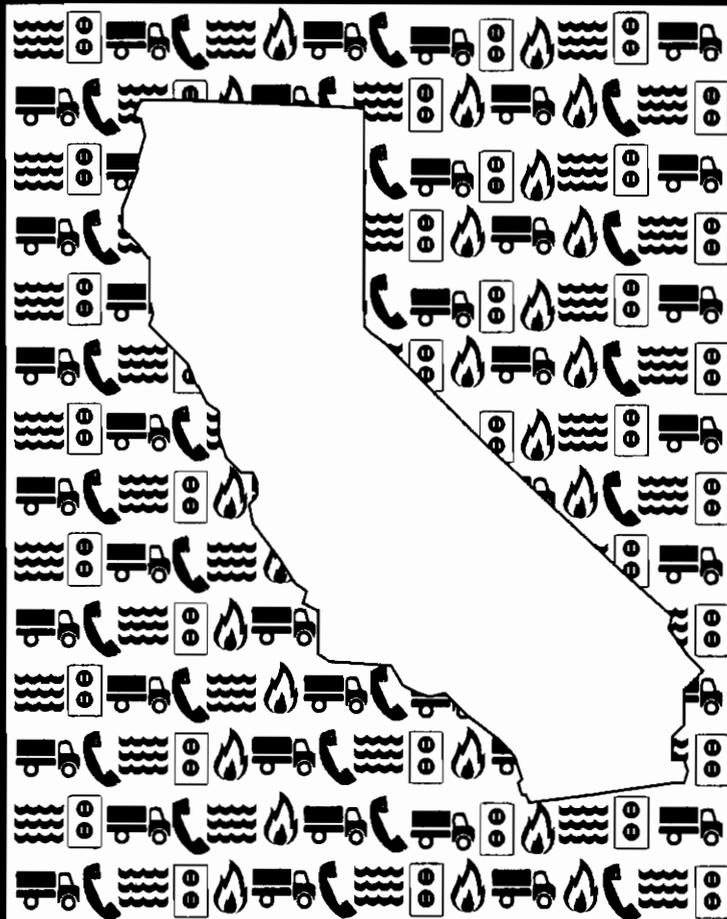


# LITTLE HOOVER COMMISSION



WHEN CONSUMERS  
HAVE CHOICES:  
*The State's Role in  
Competitive Utility Markets*

*December 1996*

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(\* Senator Alquist's Commission membership ended on December 2, 1996 -- the last day he was a Senator -- shortly before this report was adopted. Other Commissioners who served during the report's preparation but who were no longer members at the time of adoption were Senator Lucy Killea and Assemblyman Dominic Cortese.)

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December 10, 1996

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The Honorable Cruz M. Bustamante  
Speaker of the Assembly  
and Members of the Assembly

The Honorable Rob Hurtt  
Senate Republican Leader

The Honorable Curt Pringle  
Assembly Republican Leader

Dear Governor and Members of the Legislature:

Over the last 20 years, state and federal policy makers have charted a course toward competition among utility and other essential service providers -- allowing whenever possible for market forces to replace government regulation. Earlier this year, California affirmed its leadership in this pursuit with the adoption of landmark legislation establishing competitive electricity markets.

Accordingly, government structures appropriate for competitive utility services need to be created in order to obtain the maximum benefit from these changes.

The State should adopt a strategy that results in two separate commissions: one that focuses on telecommunications and the other expert in energy. Both commissions should be required to routinely seek legislative approval for significant policy changes, and should be held accountable for implementing those policies according to legislatively set goals. The commissions also should be required to gather information, deliberate on evidence and make decisions in public.

The Little Hoover Commission began this review by determining the functions that the State will need to perform now and in the immediate future. The Little Hoover Commission then identified the agencies best equipped to perform the needed functions. These are the same questions that were asked when these government structures were established over the last 100 years. But times change, and so do the needs of the governed.

The structure recommended is as fundamentally different as the emerging markets it will serve. But the recommendations also provide a reasonable path -- an evolution of responsibilities -- for making this transition while maintaining the public interest as the lodestar for government action.

The Little Hoover Commission's report, which is being transmitted to the State's top policy makers with this letter, includes findings and recommendations in six issue areas:



- **Energy.** The Energy Commission and Public Utilities Commission need to be divested of obsolete functions intended for government planners to make decisions that will soon be made instead by consumers and producers. The Energy Commission should be assigned the functions needed to facilitate competitive energy markets -- and over time assume all energy-related oversight. The PUC needs to determine what can be done to make electricity distribution competitive and to systematically retreat from the energy markets. While the State will want to maintain its public purpose programs, that function can be better administered by a department than by a commission focused on facilitating competitive markets.
- **Telecommunications.** The telecommunications industry is so dynamic and so complex that California residents and businesses will best be served if over time the PUC focused solely on telecommunications. The transition to competitive telecommunications markets will be enhanced if clear standards are established for when the PUC will cease economic regulation. And the State's telecommunications policy making will be improved if the PUC collaborates annually with the Legislature to set goals and assess progress toward those goals.
- **Transportation.** The transportation industry is nearly free from the price regulation that often protected the industry at the expense of consumers. The public interest that remains largely concerns licensing and public safety -- and the State's expertise in these areas rests within the Business and Transportation and Housing Agency. While some consumer protection needs remain, the Department of Consumer Affairs is charged with that responsibility.
- **Water.** Ironically, the last monopoly in utility services may be the investor-owned water suppliers that serve fewer than 20 percent of Californians. However, the economic challenges facing these companies are the result of water conservation requirements and increasing health standards. The PUC has been unable to adequately integrate those public policy goals into its rate-making procedures. The State Water Resources Control Board has the expertise and the legal structure that would provide a better venue for integrating those policies.
- **Consumer Protection.** As fewer decisions are made in the PUC's regulatory arena, and more consumer issues arise in the competitive marketplace, the State will need to expand the duties of the Attorney General to represent consumers in a variety of administrative, legislative and judicial forums.
- **Process and Management.** Competitive markets will dramatically increase the need for public and accountable decision making. While the Legislature made substantial progress in this area in 1996, further reforms are needed to ensure that PUC decisions concerning the marketplace are made in a factually sound, legally accountable and publicly fair manner. In addition, the PUC will be better equipped to make the needed changes if it is allowed to develop the kind of partnership between management and labor that is possible when civil service restrictions are eased.

The restructuring recommended in this report will be difficult to execute, as agencies defend their turf and companies who have developed relationships with their regulators resist efforts to shift that oversight elsewhere. The recommendations are not intended as criticism of the hard work and dedication of those who serve in any of these government agencies. The task of redefining the State's role in energy is particularly burdened by the historic friction between



the PUC and the Energy Commission and a political stalemate over how to reform the two agencies. And finally, reformers are challenged by market and technological changes that make even the near-term difficult to foresee with confidence.

But the risks associated with not reforming the structure are too great to dismiss. The transition to competitive utility markets is costing hundreds of millions of dollars, and the success of this transition rests largely on a compatible government structure. The same fortitude mustered to pursue competitive markets is needed to realign the public agencies that will be charged with helping those markets function effectively. The Little Hoover Commission stands ready to work with the Legislature and the Governor to make these reforms a reality.

Sincerely,

A handwritten signature in black ink, reading "Richard R. Terzian". The signature is fluid and cursive, with a long horizontal stroke at the end.

Richard R. Terzian  
Chairman

*Upon adoption of this report, the Commission directed that a letter of support from Senator Alfred Alquist be appended. Senator Alquist, a long-time member of the Little Hoover Commission, was instrumental in creating the California Energy Commission.*



# **When Consumers Have Choices:**

## *The State's Role in Competitive Utility Markets*

**December 1996**



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# Executive Summary





# Executive Summary

**T**he purpose of pursuing competition in utility services is to replace the inherent inefficiencies of government regulation with the promised efficiency of market forces. In making that choice, the State has the opportunity and obligation to realign its oversight of these markets and to resolve notorious inter-agency disputes and overlaps.

As soon as feasible, California needs a keen and unified energy oversight agency, schooled in the economic dynamics and environmental sciences that permeate the public interest in this area. The State cannot reach this goal overnight. But the emerging markets provide for an evolutionary consolidation of authority in the California Energy Commission that could accomplish this long-sought objective with minimal disruption to public agencies and private concerns. The chart at the end of this summary illustrates this transition.

Despite the growing faith in the ability of markets to provide utility services, the State will maintain programs intended to make up for the possible failure of the market: to utilize the most energy-efficient construction techniques and to provide research, development and demonstration of efficiency technology, renewable resources and alternative fuels. These programs, however, can best be managed by a department and, to reduce the potential of government intervention into the market, are best separated from the agency charged with market oversight.

The emerging telecommunications market by itself presents an enormous challenge. The Public Utilities Commission is uniquely qualified to nurture competition and to redefine the public interest in this rapidly changing industry. Its chances of success in this endeavor would be greatly improved if telecommunications were to become its sole focus.

Deregulation of the transportation industry is nearly complete, but the State has yet to eliminate the PUC's jurisdiction in transportation and consolidate the functions related to licensing and safety of transportation service providers so as to streamline the role of government and better serve the public. That consolidation should occur immediately, as indicated in the organizational chart.

Investor-owned water companies may be the last monopolies of the sort the PUC was created to regulate. But water quality and water supply issues now dominate the finances of the State's relatively few private water companies. The economic regulation of those companies should be moved immediately from the PUC to the State agency more familiar with those challenges.

And finally, as more Californians receive utility service from competitive enterprises, California will need to enhance the role of the Attorney General in protecting consumer interests, bolster the credibility of public decision making and enlist cooperation in managing the public work force.

The findings and recommendations in this report do not assess or endorse the policy choices that have been made in PUC hearing rooms and the halls of the Legislature to replace monopoly utility services with competition and consumer choice. Rather, they offer a government structure that matches the market-oriented choices that have been made. Where feasible, the structure removes the economic regulator when the need for economic regulation ceases to exist. Where necessary, it provides for market oversight -- such as gathering detailed information and monitoring for potential market power abuses -- that is needed for investors and consumers to make decisions. Where appropriate, it preserves public policy goals that competitive markets may shortchange, including research and development and universal access to essential services.

The findings and recommendations represent what the Little Hoover Commission believes to be the best solutions at this time. The path to competition is both promising and unknown, and the recommendations offer a course for navigating the transition.

While the recommendations set some structural goals -- such as a single

energy oversight authority -- unforeseen particulars will define the ultimate shape and timing of these changes. The best strategy the State could craft would begin with a constant commitment to assess what has been done and to make needed course corrections.

Discussions of PUC reform are often stymied by a debate over the degree that the PUC can be changed without amending the State Constitution. If that issue persists, it should be resolved expeditiously by the appropriate authorities. The Little Hoover Commission makes its recommendations independent of that issue. The government structure advocated here should be pursued -- either statutorily, or if necessary by amending the Constitution.

After 10 months of research and analysis, with the cooperation of the agencies involved, and generous assistance from the regulated companies, consumer and environmental interests, the Little Hoover Commission has reached the following findings and recommendations:

## *Energy*

**Finding 1: As presently constituted, neither the Public Utilities Commission nor the California Energy Commission is well-designed to perform the state functions needed by competitive energy markets.**

The need and political consensus to reform the State's energy regulatory structure is increasing as energy markets undergo fundamental change. Because of the physical nature of electricity and natural gas and because of their importance to the economy and public welfare, some state oversight of a competitive energy industry may be essential. The agency will have to be focused on energy and expert on the economic forces and environmental issues that shape energy markets and public policies.

***Recommendation 1-A: During the transition, the Governor and the Legislature should divest the PUC of the obsolete regulatory functions governing generation and transmission facilities.***

The PUC's economic regulation of generation and transmission facilities will not be needed when competition begins and the transmission system is managed by the Independent System Operator, which is now slated for January 1998. The PUC will no longer need to conduct environmental reviews of new generation and transmission facilities and will not be in a position to monitor safety and reliability of new generation and transmission facilities.

***Recommendation 1-B: During the transition to competitive electricity markets, the Governor and the Legislature should divest the Energy Commission of obsolete regulatory and planning functions.***

The obsolete functions known at this time are the Energy Commission's economic forecasting and needs analysis associated with approving most generating facilities, its load management responsibilities and its periodic informational reports. As competitive markets develop, additional functions may prove to be unneeded, as well.

***Recommendation 1-C: During the transition to competition, the Governor and the Legislature should assign to the California Energy Commission the new functions needed to make competitive energy markets operate.***

In a competitive electricity generation market, the State will need a consolidated siting, environmental review and safety compliance authority for generation and transmission facilities. The State also will need to provide variations of functions already performed by the Energy Commission -- in particular, the gathering and disseminating of detailed market information, monitoring for possible market power abuses and representing the State in regional, national and international regulatory venues. The Energy Commission also should be given the ability to grant facility applicants the power of eminent domain on a case-by-case basis.

***Recommendation 1-D: The Governor and Legislature should amend the electricity restructuring act of 1996 to assign to the Energy Commission responsibility for enforcing safety and reliability standards concerning the transmission grid.***

The Legislature correctly realized the important role in a competitive market of making sure that a reliable system is maintained. It is unclear at this time how much of that responsibility will rest with federal authorities. To the extent that the State can play a significant role in system reliability, that function should be consolidated with other market-oriented oversight responsibilities. One potential model would rely on the Independent System Operator to make recommendations to the Energy Commission regarding standards, notify the Energy Commission of potential violations and investigate system failures. The legal authority, however, for setting and enforcing standards should be vested in the Energy Commission.

**Finding 2: The Energy Commission's dual responsibilities as an energy regulator and an advocate for alternative energy solutions are not compatible with its new mission of encouraging competition and consumer choice.**

Emerging competition requires that the linkage between regulatory and advocacy functions be reconsidered, along with the long-term need for advocacy programs. In competitive markets government cannot pick the market solution and it must be careful in how it tries to influence the decisions that producers and consumers make.

*Recommendation 2-A: The Governor and the Legislature should transfer from the Energy Commission to the Department of Conservation the public purpose programs concerning transportation fuel research, business development, public education and market transformation programs, including the setting and implementation of building and appliance efficiency standards.*

Placing these functions in a department will make two significant reforms: It will separate advocacy from oversight and it will enable more significant changes in how the programs operate to reflect new funding and market needs. At the same time, the move would preserve the important functions that have saved Californians considerable amounts of money and facilitated the advancement of other energy-related public policies, including clean air and responsible use of other resources.

*Recommendation 2-B: The Governor and the Legislature should amend the electricity restructuring act of 1996 to consolidate the administration of energy research and development programs in the Department of Conservation. The department should establish a broad-based advisory panel to set funding priorities, review applications and advise the department director on allocations.*

The advisory panel should include key legislators, representatives of environmental and consumer groups, and the home building and manufacturing industries. The director of the department should be instructed to explore other institutional arrangements for managing the research program, including a joint powers agreement involving energy policy officials and representatives from public and private universities.

**Finding 3:** The PUC, while it will play a transitional role in nurturing competition, could jeopardize the success of the energy restructuring plans if it were to assume oversight of the competitive aspects of energy markets.

The PUC will continue to have critical tasks in the transition to competitive energy markets, in redefining rate regulation of remnant monopolies and in facilitating the evolution of distribution services. How the PUC performs those tasks will greatly influence the success of competition. And how competition unfolds will, in turn, shape the ultimate structure of the State's energy oversight agency.

*Recommendation 3-A: The Governor and the Legislature should enact legislation establishing benchmarks and a time line for delineating when and how the PUC will eliminate economic regulation of competitive aspects of the market and when and how it will encourage competition for distribution-related services.*

While the Legislature should expeditiously divest the PUC of functions that will be obsolete with the advent of competition, other regulatory functions will become obsolete over time. Thresholds should be established in statute ahead of time determining when the PUC will cease regulating in a given arena. The benchmarks also will serve to better coordinate activities between the Energy Commission and the PUC.

*Recommendation 3-B: After the transition -- after all customers have access to competitive electricity providers and performance-based rate-making is instituted for distribution monopolies -- the Governor and the Legislature should transfer the PUC's remaining energy-related functions to the Energy Commission.*

The goal of the State should be a single agency with energy oversight authority. But the State should pursue this goal in a way that does not jeopardize emerging markets or compromise consumer protection. The first step is to consolidate those new functions over the expanding competitive market into a single agency. The second step is to consolidate the regulation of remnant monopolies at the Energy Commission. The precise timing and scope of the government restructuring will depend upon market developments.

**Finding 4:** The State has a fractured and confused process for setting energy-related policies that results in conflicting public efforts with no clear venue for resolving the conflicts.

Energy is so integral to the economy and a number of environmental and resource issues -- from transportation to air and water protection -- that more than one public agency always will impact the formation and implementation of energy policy. Many of the legendary conflicts between the Energy Commission and the PUC will end as the two agencies stop the regulatory activities that attempted to make the supply and demand decisions of the marketplace. Beyond the functions of these agencies, the advent of competition provides the State with both the opportunity and the need to establish a more effective and more accountable policy-making framework.

***Recommendation 4-A: The Governor and Legislature should enact legislation requiring the Energy Commission to annually appear before the Legislature to review the agency's performance toward meeting established policy goals and set specific goals for the Commission to pursue over the next year.***

This process would allow the Legislature to better monitor and more timely influence the direction of the oversight commission, provide an opportunity for better relationships to develop and discourage venue shopping.

***Recommendation 4-B: The Governor and the Legislature should enact legislation requiring the director of the Department of Conservation to biennially prepare an assessment of the department's existing energy-related programs and propose changes to eliminate obsolete programs, improve existing programs or create new programs.***

The document should be submitted to the Governor for approval and forwarded to the Legislature for consideration as statutory amendments or budget reallocations. The document should specify what actions would need to be taken by the department to accomplish the policy changes. It should also specify what actions other departments would have to take, if any, to make the policy recommendations work.

***Recommendation 4-C: The Governor and the Legislature should enact legislation requiring the Secretary of the Resources Agency to participate as a non-voting advisor in Public Utilities Commission proceedings concerning energy-related issues.***

A significant failing of the current policy making framework is the gap between the Energy Commission, the Public Utilities Commission and the State's executive. Providing for a member of the Governor's cabinet who

also oversees the Energy Commission to take part in the PUC's energy-related proceedings would bridge that gap. This arrangement will only be needed as long as the PUC retains jurisdiction over energy utilities.

## *Telecommunications*

**Finding 5: The fast-paced dynamics of the telecommunications industry, with its importance to the California economy and the complexity of new public policy issues, is not being adequately overseen by a commission that regulates numerous other essential business sectors.**

The trends in the rapidly changing telecommunications industry create complex policy choices involving conflicting public interests. Implementing these policy choices may be just as challenging -- given the need to infuse competition into monopolies in ways that are economically sound, legally correct and satisfying to a demanding public. Because PUC decisions will influence the economic health of the market, the timeliness and quality of its decision-making is paramount.

*Recommendation 5: The Governor and the Legislature should enact Legislation directing the PUC -- after the development of competitive energy generation markets -- to focus its attention solely on the development of competitive telecommunications markets by monitoring for possible market power abuses, overseeing telecommunications public policy programs such as universal service and identifying unfair business practices.*

A number of policy reviews in recent years have found that the PUC has too many responsibilities to adequately fulfill them all. Changes in technologies and emerging competitive utility markets have increased the Commission's workload. Successful oversight of the telecommunications revolution will rest in large part on the time and focus the PUC can bring to the job.

**Finding 6: As new telecommunications technologies and services emerge, the State does not have a systematic way for determining areas of public interest or the extent of government oversight that is necessary.**

Telecommunications has not changed overnight from a monopolistic service into a fully competitive market. Rather, competition has come gradually to different parts of the telecommunications network at different times. In the past, the PUC's role has been to use regulation to

perform price setting and other market functions in the absence of a competitive market. The competitive market raises the question of what regulations if any the PUC should impose. While the PUC has conducted numerous proceedings in an attempt to fairly usher competition into the market, even its supporters do not believe the PUC has done enough to predetermine when it will stop regulating.

***Recommendation 6-A: The Governor and the Legislature should enact legislation declaring clear standards for when telecommunications services are fully competitive, when they are vulnerable to possible market power abuse or when they are so affected by the public interest that government intervention is warranted.***

The PUC should be required to use those standards to establish the scope of its activities and routinely review the consequences of those activities. The standards should include a time line and the PUC should report to the Legislature on its progress. The goal is consistent and accountable progress toward aligning regulation with the markets.

***Recommendation 6-B: Beginning in the year 2000 and every five years after that, the Public Utilities Commission should undergo a sunset review to determine if the PUC is still needed.***

The sunset review will provide at least two benefits. The first would be to make sure that any basic function, or the PUC itself, has not outlived its usefulness and is no longer providing significant benefit to Californians. The second benefit would be to provide the Legislature with the opportunity to reassess the State's role in telecommunications and the best way to fulfill those roles.

**Finding 7: The State's practice of setting telecommunications policies on a case-by-case basis encourages market players to seek the same changes from the Legislature and the Public Utilities Commission. This venue shopping spurs occasional conflicts and confusion among government entities that could prove costly to nascent competitive markets.**

In telecommunications, as in energy, it has not always been clear when the Legislature will be the venue for establishing a policy, and when the Public Utilities Commission is the appropriate policy maker. While there is some public benefit to this tension, there is evidence that in telecommunications policy the relationship between Public Utilities

Commission and the Legislature has devolved. The rapidly changing telecommunications industry and its customers will be better served by some agreement in how major and minor policies will be set.

***Recommendation 7: The Governor and the Legislature should enact legislation requiring the Public Utilities Commission, as a precursor to the annual review and approval of its budget, to collaborate with the Legislature to review telecommunications policy directions and past performance and establish specific goals that the Commission will pursue in the coming year.***

While the PUC was intended to be insulated from day-to-day politics, it cannot operate in a vacuum. Over the long term, the legitimacy of fourth-branch commissions to chart significant policy changes is enhanced by routine reality checks from directly elected legislators. Similarly, while given the authority to make tough decisions day in and day out, the PUC's legitimacy will be enhanced by an annual public accounting of its progress.

## ***Transportation***

**Finding 8: Some of the PUC's transportation regulatory activities are remnants from an era when industry asked for government intervention as a shield against the rigors of competition. Those regulations, disguised as consumer protection, can have the effect of raising prices without a commensurate benefit to the public.**

The PUC is now pre-empted by federal law from regulating rates for railroads and trucks, but has yet to abandon rate setting for other carriers. Beginning in the 1930s, when the trucking industry asked for government protection against cutthroat competition, the PUC has gradually come to confuse protecting the industry with guarding the public interest. A number of the Commission's requirements discourage new market entrants and can lead to higher consumer prices.

***Recommendation 8: The PUC should cease all transportation-related activities.***

Policy makers at the federal and the state level have determined that competition, not regulators, should set prices for transportation providers. Preserving remnants of economic regulation -- such as issuing certificates of public convenience and necessity for new providers, posting tariffs and requiring detailed financial reports -- can reduce competition and increase consumer prices without providing significant consumer benefits.

**Finding 9: The PUC's transportation safety and insurance functions overlap with the duties of the California Highway Patrol and the Department of Motor Vehicles. The overlap results in unnecessary regulation and contributes to gaps in safety.**

As the PUC's role in economic regulation has been pre-empted at the federal level, it is no longer logical for the Commission to be responsible for imposing licensing and safety regulations on passenger carriers, household movers, railroads and other common carriers.

***Recommendation 9-A: The Legislature and the Governor should enact legislation transferring the safety and liability regulation of all commercial highway carriers to the California Highway Patrol and the Department of Motor Vehicles.***

Primary responsibility for transportation in California has long been vested in the Business and Transportation Agency, and departments within that agency are responsible for licensing drivers and enforcing safety laws. Common sense and economic realities prompted the Legislature in 1996 to move safety and licensing of truckers to the CHP and the DMV. Common sense dictates that the same functions for other transportation providers be transferred to those agencies as well.

***Recommendation 9-B: The Legislature and the Governor should enact legislation putting minivans that are used to carry passengers commercially under the same safety oversight as larger passenger vehicles.***

Shuttle vans provide an opportunity for economics and convenience to actually work in favor of the State's policies of discouraging single occupancy vehicles. The State should take advantage of this trend by providing shuttle passengers the same level of safety as those of other commercial passenger carriers.

***Recommendation 9-C: The Governor and the Legislature should enact legislation moving the PUC's consumer protection functions concerning household movers to the Department of Consumer Affairs. A sunset review should be performed to determine if there is a continuing need for this specialized oversight.***

The State has an enduring interest in making sure its citizens are not cheated or victimized by thieves. The State pursues this interest daily with generalized law enforcement and consumer protection agencies and

that protection may prove to be adequate in the case of household movers.

**Finding 10: As the PUC's role as a rate setter for railroads has been eliminated, it is left with railroad safety functions that are more related to the core competencies of transportation planners and accident investigators than to those of an economic regulator.**

The PUC has retained some jurisdiction over safety for both heavy rail and rail transit systems, even though the federal government has virtually pre-empted the states from creating their own safety programs. The public interest demands a continued state role in rail safety, but how the State can best fill that safety role is influenced by the place of rail in the State's overall transportation scheme.

***Recommendation 10: The Governor and the Legislature should transfer the PUC's rail planning and safety functions to the Business, Transportation and Housing Agency.***

The precise form the new consolidated program will take should be based on a thorough review of how to best link rail safety with statewide rail planning and how to best coordinate funding of safety projects within Caltrans to avoid the conflicts that have slowed projects in the past.

## ***Water***

**Finding 11: While the rates charged by private monopoly water providers still need government scrutiny, the greater public interest lies in ensuring adequate and safe drinking water supplies -- challenges that fall outside the PUC's expertise of thwarting monopoly abuse.**

Water companies in California face the dual challenges of meeting federal water quality standards and conserving water supplies to provide future customers. The PUC's focus on protecting customers by keeping rates as low as possible impedes companies from fulfilling these needs. These issues -- along with dramatic changes underway in the energy and telecommunications industries -- provide the opportunity to reconsider the State's choices for economic regulation of private water suppliers.

***Recommendation 11-A: The Governor and the Legislature should enact legislation transferring the economic regulation of the private water suppliers from the PUC to the State Water Resources Control Board.***

The State has more choices today for assigning the economic regulation of private water companies than it did at the dawn of the century when utilities shared the commonality of monopoly status. The State Water Resources Control Board has the procedural experience and the water expertise needed to address the primary concern facing California's water suppliers and their customers -- a safe and adequate supply over the long term.

***Recommendation 11-B: The State Water Resources Control Board should investigate and implement incentives for consolidating small water companies and for financing water quality and efficiency improvements to water systems.***

The State Water Board is the agency best suited to bring about these changes, but the opportunity provided by federal loans and the willingness of some larger systems to take over small, under-financed companies should be pursued by whatever agency has responsibility for regulating the private water industry.

## ***Consumer Protection***

**Finding 12: In competitive markets, as public decisions may be diffused, residential and small business customers may not be well-represented in a number of regulatory, legislative, administrative and judicial venues.**

The original purpose of the PUC was to protect consumers in the absence of a functioning market. The State's new strategy is to facilitate the market wherever possible -- policing those industries as it does others for antitrust behavior and consumer fraud. As utility services become competitive, the role of the PUC will shrink -- requiring other agencies, most notably the Attorney General, to play a larger role in consumer protection.

***Recommendation 12: The Governor and the Legislature should create within the Attorney General's Consumer Law Section an office of utility consumer protection. The office should represent consumer interests in legislative, administrative and judicial proceedings.***

The Attorney General in the past has relied more on the full-service regulatory strategy of the PUC to protect utility consumers. As the monopolies give way to the market, the Attorney General's role in this arena will naturally increase. To encourage cooperation, prevent

duplication and provide effective consumer protection, resources and expertise should be shifted over time to enable the Attorney General's Consumer Law Section to better fill this role. The legislation should specify that the unit will employ a combination of attorneys, engineers, economists and policy analysts and will be funded by reallocating a portion of the existing user fees assessed to fund the Public Utilities Commission and the California Energy Commission.

## *Process and Management*

**Finding 13: The PUC's procedures, even as amended by the Legislature in 1996, provide the least accountability to the public and the fewest assurances that decisions will be based on the factual record in precisely those cases where the greatest profits and the greatest public interests are at stake.**

As the PUC participates in the development of competitive utility markets and its jurisdiction is curtailed to focus solely on telecommunications, the credibility of its decision-making procedures will be critical. The PUC envisions spending less time in the judge-and-jury role of a full-time regulator and more time setting policy -- defining the public interest and shaping the rules that market players and consumers will live by. Commissioners have asserted that policy making is legislative in nature, and when acting as legislators they should be given freedom to meet privately with stakeholders and among themselves. The Commissioners also asserted that they should retain freedom from expanded judicial review, effectively making their decisions final. Freedom, however, must be commensurate with accountability. It should not be granted in a way that erodes confidence in public decision making.

***Recommendation 13-A: The Governor and the Legislature should amend the Public Utilities Code to limit ex parte contacts after a proposed decision is issued in rule-making proceedings to meetings in which all the parties are invited to attend. All private meetings and discussions between Commissioners and parties with a matter pending before the Commission should be noticed and summarized for the public record.***

The Legislature in SB 960 made significant improvements in the PUC's decision-making process. That effort could be further advanced by increasing the accountability in policy-making proceedings, as well. The greatest conflict between the need for Commissioners to discuss issues with individual parties and the need to preserve the integrity of a fact-

based process from political lobbying comes after proposed decisions are issued. The integrity of the process will be further enhanced if the notification procedures are expanded to include substantive policy discussions between Commissioners and parties -- even if they are not based on the particulars of a pending case.

***Recommendation 13-B: As the workload of the PUC is reduced -- and as some of its functions are transferred to agencies more suitable to perform them -- the Legislature and the Governor should enact legislation requiring Commissioners to rely solely on open meetings to gather information and make public decisions.***

Even when acting in a policy-making capacity, Commissioners differ fundamentally from legislators: They are not elected and so are never held directly accountable to the public. And with a membership of only five, the effects of special interest lobbying are significantly more concentrated than in a 120-member legislature. As the number of market players increases, the importance of giving everyone a chance to speak -- and to listen to the arguments made by their adversaries -- will increase in importance. As its caseload is diminished by transferring some responsibilities to agencies better able to perform them, it will be more possible for the PUC to rely on an open decision-making process.

***Recommendation 13-C: The Governor and the Legislature should grant parties a right to appeal all PUC decisions, or the decisions of its successor agencies, to the court of appeal.***

Experience in other states suggests that the accountability provided by broader judicial review can be achieved without significant delays in the public process. To encourage uniformity of decisions and subject expertise, appeals should be restricted to the court located in the same city as the Commission, now the First District Court of Appeal in San Francisco. The standard of review should include a review of the facts to determine whether they support the Commission's decision.

**Finding 14: The Commission's reputation for hiring and promoting the best and the brightest is being undermined by the rigidity of civil service rules.**

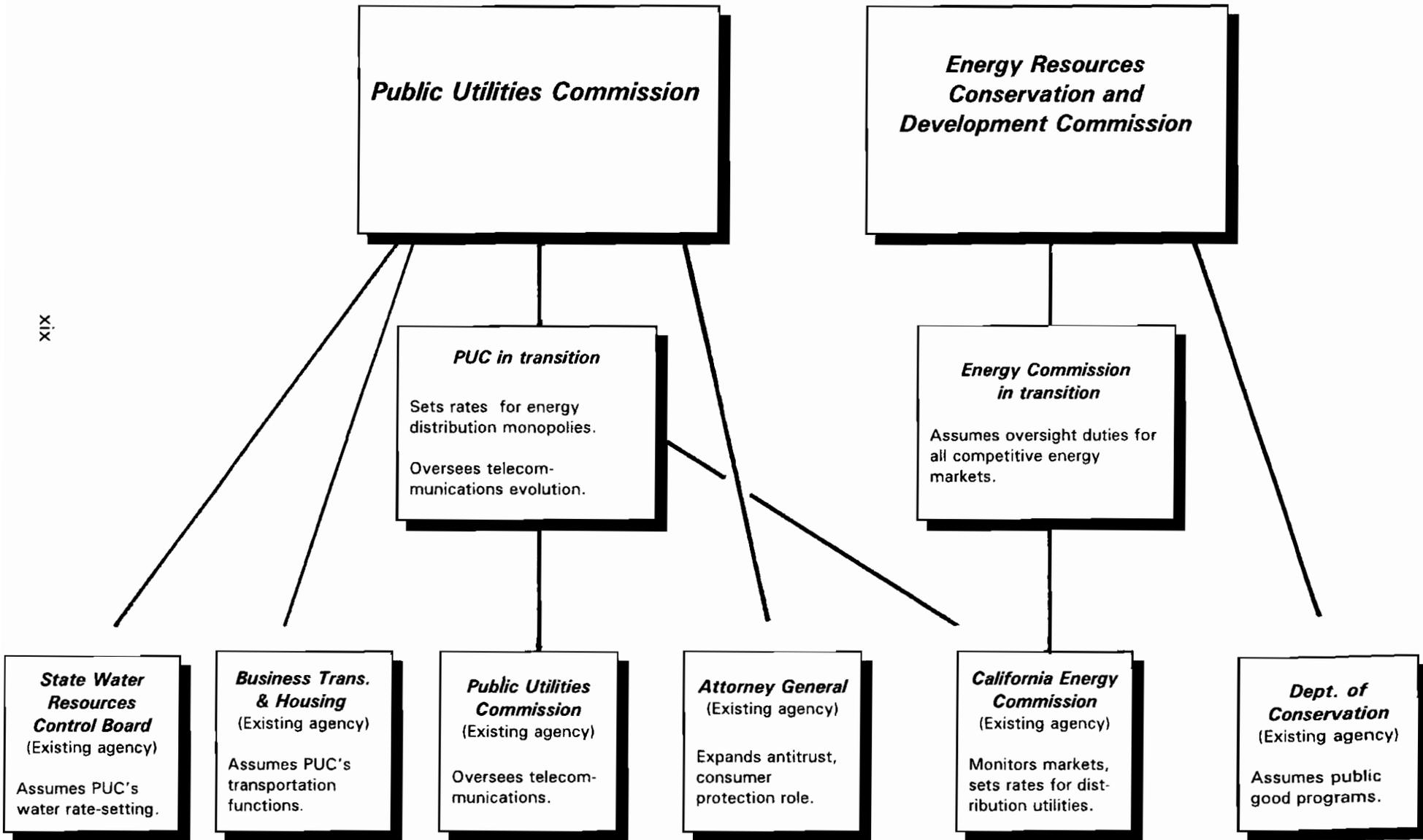
The civil service system rigidly prescribes how managers will make decisions concerning job assignments, rewards and punishments. Keeping the PUC's energy focused on serving the public interest as it transforms itself for a post-monopoly future, will require the Commission to be able to tap the deep skills and full creativity of its staff.

***Recommendation 14: The PUC should apply to the State Personnel Board for permission to initiate a demonstration project. The project should allow for the creation of broader classifications and pay for performance. The Commission should initiate a labor-management council for anticipating, assessing and resolving labor-related problems that will result from the near-constant change facing the Commission.***

As the PUC's role radically shrinks, it is in a unique position to benefit from the flexibility that the Legislature already has granted to state agencies facing considerable changes and looking for ways to forge a partnership between management and labor that transcends the rigidity of the civil service rules. While the Energy Commission has a reputation for involving employees in changes, it also might benefit from the flexibility of a civil service demonstration project as it goes about redefining its mission to meet the needs of competition.

# *PUC & Energy: An Evolution of Responsibilities*

XIX





# Introduction





# Introduction

**P**ublic agencies often are solidly built on the political landscape of the day. But over time, technological possibilities, economic realities and changing public preferences erode the reasoning upon which the agencies were constructed. As change occurs, agencies scramble to stay effective, even relevant. Organizational structures created to protect the public interest develop overlaps and gaps.

Such is the case in the regulation of public utilities and other essential services. Federal policy reforms, technological advances and increasing inefficiencies associated with monopolistic utilities are radically changing these industries. Common sense dictates that government keep pace with the governed.

The Little Hoover Commission began its review by examining the roles of the Public Utilities Commission and the California Energy Resources Conservation and Development Commission -- two agencies that once worked well on behalf of Californians, but in more recent years have struggled to collaboratively develop and implement cogent energy policies.

In order to comprehensively deal with utility oversight, the Little Hoover Commission then reviewed the PUC's responsibilities concerning telecommunications, transportation and investor-owned water services.

Throughout, this study was guided by two fundamental questions: Given the changes that are occurring in these industries, what is the role of the State? And, second, what agency --- existing or new -- is best suited to fill that role?

Once future functions were defined, the Little Hoover Commission considered the appropriate structure for grouping those functions. It then reviewed the general procedures those agencies should use and how those agencies should relate to each other and the Legislature.

The analysis revealed that there are no perfect answers to these questions. And a widely held concern is that as events unfold new issues will emerge and the State will have to adjust its policies.

The Little Hoover Commission believes its recommendations represent a technically sound and realistic approach that resolves long-standing problems, provides for the needs of market-based utilities, and allows for the State to adapt as challenges arise that are unpredictable today. Moreover, in an era of uncertainty, the recommendations strive to preserve the public interest as the lodestar for State actions.

The Little Hoover Commission has examined these issues three times in the past: in 1974, when the Energy Commission was newly created and its architects were interested in how it would relate with the PUC; in 1984, when tension developed between the PUC and the Energy Commission; and, in 1995, when the Little Hoover Commission fulfilled a statutory obligation to review a Governor's Reorganization Plan of the Energy Commission.

To assist in this study, the Commission assembled two advisory committees -- one on energy issues and the other on telecommunications, transportation and water issues. Each committee included more than 50 public officials, academic experts, industry, environmental and consumer advocates. (The names of advisory committee members are contained in **Appendix A**.) Combined, the committees met more than a dozen times to provide the Commission with insight into the history and trends of the marketplace and the state agencies being reviewed.

The Little Hoover Commission conducted five days of public hearings in San Francisco and Sacramento -- receiving testimony from 45 witnesses. (The names of witnesses are contained in **Appendix B**.) It examined the transcripts and reports generated by years of discussion concerning the existing government structure, reviewed the academic and trade literature and interviewed experts throughout the nation.

The Commission's conclusions are documented in this report, which begins with a Transmittal letter, an Executive Summary and this Introduction. The following sections include a Background and six chapters -- Energy, Telecommunications, Transportation, Water, Consumer Protection and Process and Management. The report ends with a Conclusion, Appendices and Endnotes.

# Background

- ❖ *PUC-regulated industries were stable until the 1970s, when the energy crisis, stagflation and a distrust of government forced the PUC to change its methods.*
- ❖ *The Energy Commission's charge to advance long-term policy goals such as efficiency and resource management has conflicted frequently with the PUC's short-term goal of keeping down utility rates.*
- ❖ *A number of technological advances, economic realities and political choices have allowed competitive pressures to erode away the monopolistic nature of public utilities and essential services.*
- ❖ *While public policies have sought to eliminate economic regulation of most utilities, private water services remain monopoly providers.*



# Background

As the 21st century approaches, energy and telecommunications are evolving from stable utilities into dynamic enterprises, redefining economies and lifestyles. Where corporate monoliths once controlled the field, a rush of entrepreneurs and investors are seeking to provide goods and services competitively. Where government regulators once stood sentry over the public interest, policy makers are re-examining the nature of that interest and the best way to protect it.

The definition and defense of the public interest has never been stagnant. The Public Utilities Commission has matured over the last century to balance the needs of corporate monopolies, captive customers and the larger public good. Over the last 20 years, the California Energy Resources Conservation and Development Commission has integrated environmental planning, energy efficiency and technology development to reduce air and water pollution, meet swelling energy needs economically and avoid the hardships of shortages.

This regulatory strategy has produced huge successes and notorious failures -- and it has prompted California to become a pioneer in the restructuring of essential service industries. By aggressively pursuing market trends and implementing federal policy reforms, California is trying to replace government regulation of energy with competition and consumer choice. Similar pressures require the State to rethink its role in three other industries regulated as public utilities and common carriers -- telecommunications, transportation and investor-owned water service.

This Background describes the present energy regulatory structure and important events that have challenged its effectiveness. It reviews the evolution of telecommunications and transportation regulation, and describes the challenges of the investor-owned water service industry.

## *The Regulators*

While a score of government agencies have a hand in how energy is produced and consumed in the State, two agencies are the central authorities: the California Public Utilities Commission (PUC or CPUC) and the California Energy Resources Conservation and Development Commission, better known as the Energy Commission. In the case of telecommunications, the PUC is the State's primary agent. And in the case of transportation and privately owned water systems, the PUC is only one of several agencies with oversight responsibility.

The PUC is the product of a century-long evolution. In California, the railroads were the first among the nascent modern-day utilities to abuse their control of the market to exact unfair rates and discriminate against captive customers.

The Legislature responded by creating a State Board of Transportation Commissioners. By 1879, the agency had become an elected Railroad Commission, was embedded in the Constitution and charged with ending corruption and market abuses. The Commission, however, was impotent against the railroad robber barons. The problem, as described by one present day PUC Commissioner, was the lack of "a judicial capacity to maintain a sustained disciplinary presence" over an industry with multiple and changing public interests:

*What was a reformer to do? How was one to gain the advantage of a sustained presence of a nonpolitical authority which could develop expertise in understanding the dynamics and economies of business affected with the public interest? The answer was to invent the regulatory commission.<sup>1</sup>*

As part of the Progressive Era reforms, the Railroad Commission in 1911 was established in the California Constitution as a five-member panel appointed by the Governor and confirmed by the Senate to staggered six-year terms. Commissioners were forbidden specific conflicts of interest and could only be removed for incompetence, corruption or neglect of duty as determined by a two-thirds vote of the Legislature.<sup>2</sup>

That same year, the Legislature adopted the Public Utilities Act, assigning the Commission regulatory authority over a range of private companies, many of them with overwhelming shares of the market and engaged in businesses so critical to the community welfare that the U.S. Supreme Court had found them to be "clothed with a public interest."<sup>3</sup>

In 1946 the Legislature changed the Commission's name to the Public Utilities Commission in recognition of the agency's broad reach over everything from power, heat and light to wharfages and telegraphs. The constitutional roots are often cited as the foundation for the Commission's independence. But its greatest legal powers have been granted by the Legislature, most notably in Section 701 of the Public

Utilities Code: "The Commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

While some of the Commission's regulatory authority has been pre-empted by federal law, the PUC in 1995 established rates for \$50 billion worth of commerce -- scrutinizing the bottom line of 655 privately owned natural gas, electric, telephone, water and sewer and pipeline companies, while overseeing 54,000 truck, bus, railroad, light rail, ferry and other transportation companies.<sup>4</sup> Despite this breadth, the PUC and the industries it regulates were relatively stable for the middle decades of the century. In some respects, the job of Commissioners became routine with time -- as technological advances and the economies of scale resulting from the State's growth combined to keep utility rates steady, and often declining in real terms.

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***"The Commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."***

***Public Utilities Code 701***

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During this time, the relationship between consumers, the PUC and the utilities became represented by an unwritten "regulatory compact" in which the utilities agreed to price- and service-related regulation in exchange for the exclusive right to serve a specific area and a guaranteed rate of return on investment.

The stability ended with the energy, economic and environmental crises of the 1970s and early 1980s. In those years, Commissioners struggled to help the capital-intensive utilities ride out periods of high inflation and rising fuel costs. They simultaneously tried to respond to consumer advocates, who wanted to mute rapidly increasing rates, and environmentalists, who wanted to reduce the public costs of pollution and meet growing energy demands through efficiency.

An overall distrust of government increased the pressure for public input and open decision-making procedures. And as federal law gradually pushed for more competition in both energy and telecommunications, new market players gained a stake in PUC proceedings -- creating still more interests that needed to be balanced.<sup>5</sup>

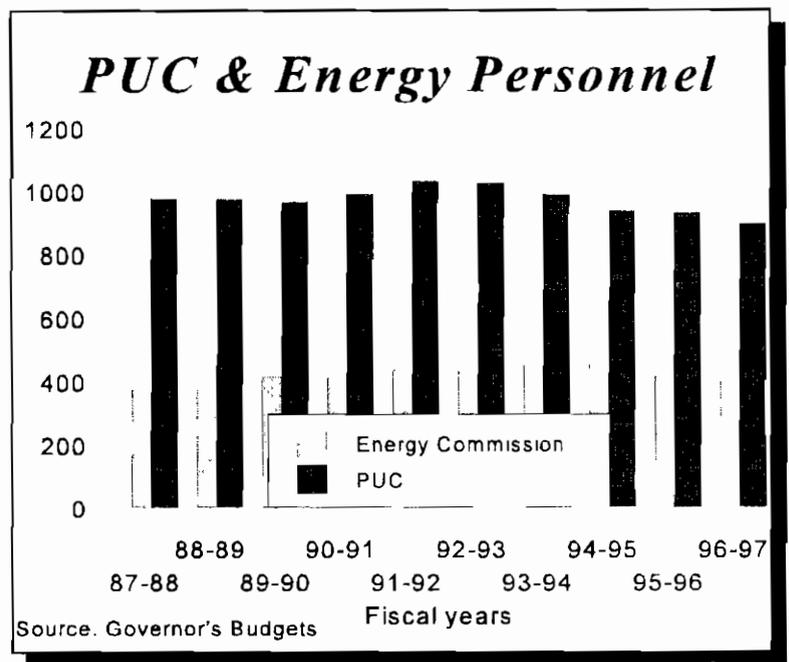
The growing number of participants was accompanied by a growing number of statutory mandates: to administer conservation programs, monitor contracts between independent energy producers and utilities and enact subsidies for low-income consumers. Even some of the PUC's traditional duties became more complicated as utilities requested rate hikes to cover the costs of overdue and over-budget nuclear power plants.

The consequence of these developments was that the PUC abandoned its passive role of assessing utility proposals for fairness and efficiency, and began to scrutinize and manipulate utility decision-making. A former high-ranking PUC staff member, in a book analyzing these trends, concluded:

*I argue that contemporary regulation is interventionist, meaning that there has come to be considerable regulatory involvement in decisions that were previously made entirely by utility managers or approved by regulators after minimal review. This recent regulatory strategy has generally had two related motivations: to minimize cost (and thus rate) increases and to minimize impacts of these increases on utility customers.<sup>6</sup>*

The political and economic trends also made obvious two large deficiencies in the Commission's approach: First, by giving companies a guaranteed rate of return on expenses, the utilities were encouraged to build more plants, hire more people and focus on the short-term horizon between rate cases -- which contributed to reliability but put constant upward pressure on prices. Second, while the PUC controlled the investor-owned energy utilities, it had little sway over the broader policies that determined how energy was produced and consumed.<sup>7</sup>

The Energy Commission was formed in 1974 to counter those regulatory failures. Its duties went beyond the electricity and natural gas delivered by monopolies to understanding and influencing all of the State's energy uses. But while the PUC's control is nearly absolute over the monopolies, the Energy Commission's regulatory authority is limited: It sets building and appliance efficiency standards to reduce energy consumption, and it approves site applications for new large thermal power plants. The Energy Commission also was vested with a number of public purpose programs intended to promote development of cleaner, renewable and other alternative energy sources.<sup>8</sup>



*The PUC's ranks have declined in recent years, while the Energy Commission's numbers have held steady or increased.*

At its inception, the Energy Commission's facility siting authority was its greatest. The RAND Corporation in the 1970s warned the Legislature that to meet the State's 7 percent annual increase in electricity demands, a series of nuclear plants would have to be built.<sup>9</sup>

The ensuing debate galvanized competing concerns -- that nuclear reactor domes would be riveted every 20 miles to the California coast and, alternatively, that public protests would prevent any new generators from being built.

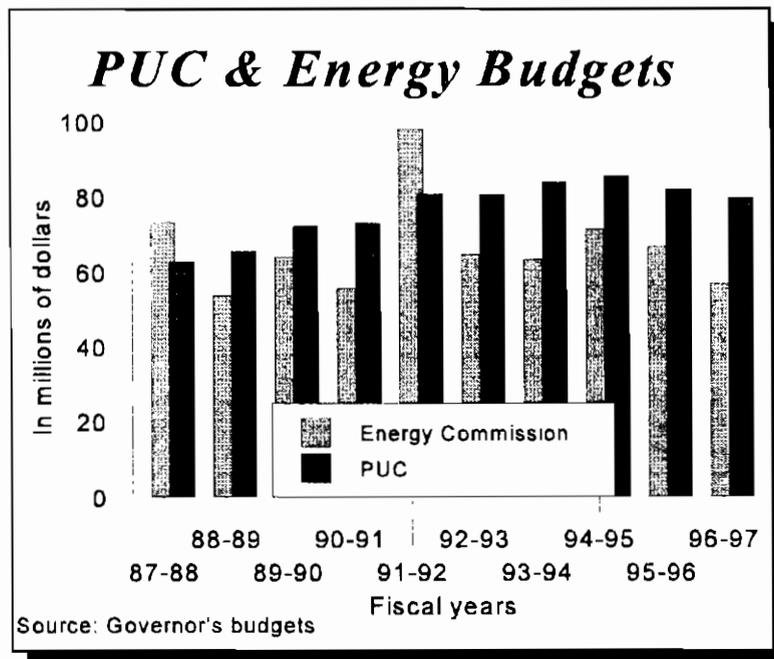
The solution was to assign to the Energy Commission the duty of gatekeeper, letting through only those new electricity generating sources that mitigated environmental impacts and were needed after efforts were made to reduce electricity demands through efficiency improvements.

With some initial controversies and midcourse corrections, the Energy Commission is widely acknowledged for succeeding in that charge -- enabling the State to accommodate a rapidly growing population and economy with investments in demand-management technologies.

Unlike the constitutionally based PUC, the Energy Commission is a creature of statute: Five commissioners are appointed by the Governor and confirmed by the Senate to five-year staggered terms. One commissioner is required to have a background in engineering or physical science, one in law, one in environmental protection, one in natural resources economics, and one represents the public at large.

Both commissions are characteristic of "fourth branch" agencies that have been created in this century to deal with complex public policy issues. They were granted policy making and adjudicatory authorities so they could efficiently regulate or promote public interests in the marketplace. The tradeoff for that efficiency has been a diminished accountability inherent in typical executive-branch departments and a muting of the checks and balances intended between the executive, legislative and judicial branches.

As the State rethinks its role in the market, it will need to reconsider whether the tradeoffs made in creating fourth-branch agencies are still appropriate or if they need to be redefined. But an even more important consideration will be to create a structure that avoids the notorious conflicts that developed between the Energy Commission and the PUC.



*The PUC's budget, derived from industry fees, has declined slightly as deregulation has accelerated. The Energy Commission's budget contains significant one-time money for grant and loan programs that wax and wane with funding.*

From the inception of the Energy Commission, the two agencies have at best displayed the behavior of rival siblings. The PUC was the only state agency that urged the Governor to veto the Warren-Alquist Act -- arguing that either it or another existing agency could perform all of the duties that were to be assigned the new commission.<sup>10</sup> More important than any overlap, however, were the conflicts that developed between the PUC, and its short-term interests in keeping energy costs low over the three-year horizon of a rate decision, and the Energy Commission's long-term interest in efficiency and resource protection. The consequences were described by a public manager with experience in both agencies:

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***“California has paid a high price for the conflict between the two agencies... interagency turf battles; forum shopping on the part of interest groups; and a resulting energy policy that is neither focused, implemented efficiently, nor friendly to the State’s citizens or its business community.”***

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*California has paid a high price for the conflict between the two agencies. The price has come in the form of arcane, interagency turf battles; forum shopping on the part of interest groups; and a resulting energy policy that is neither focused, implemented efficiently, nor friendly to the State’s citizens or its business community.<sup>11</sup>*

The conflicts have severely tarnished the otherwise significant achievements the State has made in energy policy. And of greater importance today, despite assertions by both agencies that diplomacy guides their actions, both agencies see their duties expanding to include state oversight of competitive markets, raising the likelihood that the conflicts will resume.

### ***Regulators: Pressures to Change***

Over the last decades, the tensions and disputes between the Energy Commission and the Public Utilities Commission increased to a point that required recurring attention from lawmakers. But despite considerable efforts, wholesale reforms have been elusive.

The Legislature has created joint committees, formed working groups, established task forces and attempted political negotiations in its efforts to identify the key problems and legislate solutions. In one such effort, Senate Concurrent Resolution No. 7 of 1989, lawmakers declared at the outset that the existing system “has resulted in significant fragmentation, duplication, overlap and confusion in the formulation and execution of state energy related functions.” Over the next two years, a special joint committee held hearings, hired consultants and issued recommendations for coordinating energy programs and merging many of the functions of the PUC and Energy Commission into a single agency. Few reforms were enacted into law.

The controversy escalated between 1992 and 1994, when the legislative leadership and the administration took divergent paths toward organizational reform. The administration looked at structural changes as a way of reducing government expenses, while the legislative leadership pursued reforms intended to reduce policy disputes. During 1992 budget debates, which were burdened by the recession-spawned revenue crisis, Assembly Republicans urged that the Energy Commission be eliminated to save money.

The proposal failed, but that winter a team of senior legislative staffers were assigned to examine the issue. The group identified overlaps between the two agencies in the areas of conservation, research and development and advocacy for cleaner and more efficient technologies. Increasingly, however, the group focused on criticisms aimed at the decision-making procedures employed by the Public Utilities Commission.

In January of 1993, the Governor's budget summary proposed eliminating the Energy Commission. And in the spring of 1993, SB 141 (Alquist) and SB 142 (Rosenthal) were introduced to address duplication identified by the legislative working group.

The administration did not take a position on the bills.

That summer, language was added to the 1993-94 budget bill requiring the administration to develop a reorganization plan by December 1, 1993 -- otherwise the budgets of both Commissions would automatically be cut by 7.5 percent for the rest of that fiscal year. On December 1, 1993, the Governor proposed abolishing the Energy Commission "to reduce the size and scope of governmental activity in an arena which is increasingly dominated by competition and market forces."<sup>12</sup>

### *A Generation of Attempted Reforms*

- 1974** Little Hoover Commission recommended ways to improve PUC planning and decision-making procedures.
- 1979** Legislature's Joint Committee on Energy Policy and Implementation called for separating Energy Commission's regulatory and program duties.
- 1984** Little Hoover Commission recommended ways to integrate planning and resolve disputes between PUC and the Energy Commission.
- 1984** Consultants Touche Ross identified 28 state energy-related agencies -- raising concerns about the roles of the PUC and Energy Commission.
- 1989** Joint Committee on Energy Regulation and the Environment launched a two-year study that concluded many PUC and Energy Commission functions could be merged into a single agency.
- 1992** During recession-spawned budget battle, Assembly Republicans urged elimination of the Energy Commission to save money.
- 1993** The Governor proposed eliminating the Energy Commission. Legislative committees considered reforms to PUC procedures and to eliminate overlaps between PUC and Energy Commission.
- 1994** Lawmakers nixed administration's bills to give Energy Commission duties to the Department of Conservation and create a facility siting board.
- 1995** The administration proposed its 1994 plan as an administrative reorganization. The Little Hoover Commission, with some dissenting votes, endorsed the plan. The Senate rejected the plan.

The plan also would have eliminated the State Lands Commission, transferred the functions of both agencies to the Department of Conservation and created a Facility Siting Board to provide consolidated reviews of all new energy facilities.<sup>13</sup>

In the spring of 1994, SB 2048 (Leonard) and AB 2468 (Conroy) were introduced embodying the administration's plan. The Senate and Assembly policy committees, however, became increasingly focused on reforming the PUC. Eventually negotiations between the legislative staff and the administration broke off. The administration's bills died after environmental groups and the utilities opposed them.

In January 1995, the administration proposed making those same changes under its authority to administratively reorganize executive agencies. The Little Hoover Commission reviewed the plan as required by statute and a majority of commissioners endorsed it with some recommended changes. The Senate, however, voted down the plan.

By 1996, the drive to reorganize the state energy-related agencies had acquired an added impetus. The dramatic restructuring of the energy industry itself would eliminate the vertical monopolies that are the foundation of PUC regulation and eliminate government planning for electrical generation that the Energy Commission was created to perform. In addition to its landmark work restructuring the energy industry, the PUC launched an internal review to rethink its mission in a competitive era. The project, called Vision 2000, invited utilities and interest groups that participate in commission proceedings, as well as the commission staff, to critique the PUC's internal workings and help to identify solutions.

The Vision 2000 document recognized that the industries were changing in different ways and at different paces, that old regulations did not work and there was a need for "new regulatory techniques which rely on well-structured incentives supplemented by strong enforcement programs to protect against market abuses." Based on that process, the PUC in the summer of 1996 adopted a plan that replaced an internal structure based on the role staff played -- advocacy, advisory and compliance, consumer protection, safety enforcement -- to one based on

### ***Beyond Regulation: How to Remain Relevant***

The PUC's desire to remake itself -- and preserve for itself a role in the restructured market -- is being played out in utility commissions across the nation. A 1996 report prepared for the National Association of Regulatory Utility Commissioners (NARUC) described ways that commissions could survive deregulation of the industries they were created to regulate:

*Regulatory commissions remain relevant and in control of their environments by creating effective organizations, applying effective methods of regulation and convincing others of their worth. Failure to adequately adapt to changing circumstances can cause them to lose control of their environments.*

The report, *Transforming Public Utility Commissions in the New Regulatory Environment: Some Issues and Ideas for Managing Change*, was prepared by the National Regulatory Research Institute, NARUC's research arm.

the industries the Public Utilities Commission regulates -- telecommunications, energy, rail safety, carriers and water. The plan was widely criticized by the PUC staff, the utilities, small businesses and special interest groups for dealing with structure before process, and especially for its attempt to blend the advocacy and advisory staff within the PUC.

The Commissioners saw Vision 2000 as a pivotal opportunity for the PUC to remake itself in the image of the new markets, and especially before the Legislature remade the agency. One Commissioner said the situation reminded him of a quote from a Harvard University president, which he paraphrased:

*He declared to the senate of the university that the last phase of an organization in a death throe is that it shifts its focus from serving an external societal purpose to an overriding concern with conserving the state of its constituent members.*<sup>14</sup>

The issues of restructuring the energy industry and reforming the PUC converged in the summer of 1996 with the passage of a bill on electrical restructuring and two bills that dealt with PUC procedures.

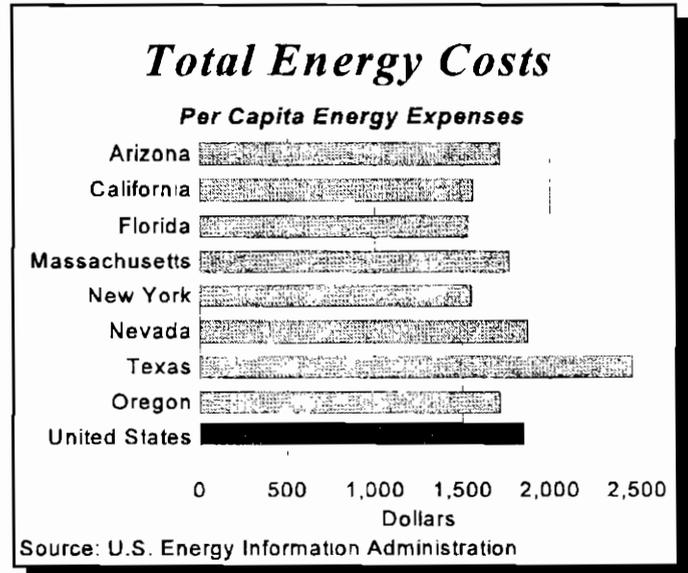
- **Electrical restructuring.** AB 1890 (Brulte) authorized the collection of transition costs to reimburse the utilities for investments that will be worth less in competitive markets, created an Independent System Operator to govern the transmission network and effect trades, continued funding for research and development, reaffirmed the State's commitment to commercialize renewable resources and staked out the PUC's responsibilities to protect consumers from overaggressive marketing.
- **PUC procedural reform.** SB 960 (Leonard) recreated a ratepayer advocacy unit in the PUC, required commissioners to be more involved in the fact-gathering processes, and created three classes of procedures -- quasi-judicial, quasi-legislative and rate-making.
- **Judicial review.** SB 1533 (Calderon) allowed for PUC decisions in adjudicatory cases to be appealed to the appellate court and for the court to determine if decisions are based on the evidence in the case.

The bills substantially dealt with some of the most pressing issues before the Legislature, particularly those associated with the PUC's plan to restructure electricity service. But other issues prompted by rapidly changing utilities were not resolved. Among the remaining issues are the government functions that will be needed in the future, the best structure for accomplishing those functions and the procedures and policy making paths those agencies should follow.

## Energy

Three forms of energy -- electricity, natural gas and transportation fuels -- comprise 85 percent of the developed energy consumed in the State. These three forms also define the majority of energy-related policy issues -- debates that involve a combination of economic forces, technological developments and political preferences.

The United States spends nearly \$500 billion on energy each year, and Californians are responsible for about a dime out of every dollar spent. The typical California resident served by an investor-owned utility spends \$65 a month on electricity and \$32 a month on natural gas.<sup>15</sup>



*Energy costs are influenced by transportation factors, climate, and fuel sources, as well as electricity rates.*

**Electricity.** Electricity accounts for only 10 percent of the energy consumed in California, but that fact understates its value in the energy mix. Electricity accounts for nearly 50 cents out of every dollar spent on energy, and for most uses it is a commodity with no practical substitute. The State's network for providing electricity is elaborate: 19,000 power plants, 2,500 substations, 40,000 miles of transmission lines. In California, five investor-owned utilities, 26 municipal utilities, four irrigation districts and five rural electric cooperatives provide power.

But 75 percent of the electricity is provided by the three largest investor-owned suppliers. Pacific Gas and Electric Company, headquartered in San Francisco, with a service area roughly from the Oregon border to the Tehachapi Mountains, is the largest investor-owned power utility in the nation with electricity revenue in 1995 of \$9.6 billion. Southern California Edison Company, headquartered in Rosemead, is the nation's second largest investor-owned electricity provider with 1995 revenues of \$8.4 billion. And San Diego Gas and Electric Company had 1995 electricity revenues of \$1.5 billion.

Equally important are the State's government-owned electricity suppliers. These government agencies vary greatly in size -- from the Los Angeles Department of Water and Power, which generates and sells electricity, to communities like Anaheim that distribute power purchased from federal authorities and private generators. The government-owned utilities were created as an alternative to private monopolies and generally operate under the rules established for government agencies: elected officials, open meetings and public referendum of decisions. They are not regulated by the PUC.

The large investor-owned and municipal electricity providers are vertical monopolies, owning and controlling the generation, transmission and local distribution of electricity.

For more than a decade, the generation aspects of the industry have become increasingly competitive. New technologies have emerged that can produce electricity cheaper than the technology of older and larger power stations. Federal laws have passed requiring utilities to purchase power from independent producers. And more recent federal reforms have effectively required the owners of transmission facilities to become common carriers, opening wider the market for wholesale electricity transactions.

Encouraging more competition among generators and allowing for retail trades will require placing the transmission system into the hands of an independent dispatch entity called the Independent System Operator. Most industry, academic and government experts see the distribution system remaining a monopoly for the near term.

**Natural gas.** Natural gas is provided by a network of pipelines that deliver the gas from producing regions, such as Canada and the southwestern United States, to areas where it is used. The largest distributors of natural gas in California are Pacific Gas and Electric Company, with annual gas revenues of \$1.1 billion, Southern California Gas Company with annual revenues of \$2.6 billion, and San Diego Gas and Electric Company with \$310 million in annual gas revenues.

Federal regulation of interstate gas transactions has largely shaped industry trends. In the mid-1970s, strict regulation of the pricing of interstate gas discouraged exploration and production, resulting in winter-time shortages and higher prices than consumers would have paid under relaxed regulation. In 1978 Congress passed the Natural Gas Policy Act, which deregulated the price of newly discovered natural gas and eliminated the distinction between interstate and intrastate gas. While simple in concept, the process of turning pipelines into common carriers has been criticized for its complex and lengthy implementation.

The PUC's rate-making role has largely been to regulate the investments

### ***Bulking Up For Competition***

In October 1996, two of California's large investor-owned energy utilities announced that they would attempt to merge their operations in anticipation of competitive energy markets.

Enova Corp., the parent company of San Diego Gas and Electric Company, and Pacific Enterprises, the parent company of Southern California Gas Company, said the merger would better position them to compete for energy customers throughout the southern part of the State. It would immediately create a company with \$4.25 billion in annual sales.

The merger will require approval of the PUC, the Federal Energy Regulatory Commission, the Nuclear Regulatory Commission and the shareholders of both companies.

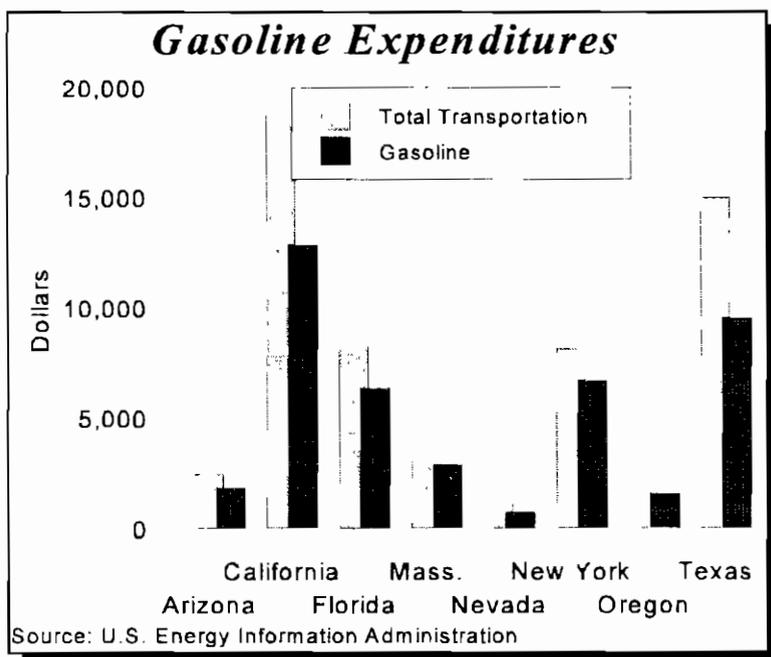
In 1991, a proposed merger of Southern California Edison Company and San Diego Gas and Electric Company failed after critics argued the proposal was anti-competitive.

and pricing of the distribution facilities operated by the investor-owned monopolies. In California, the result has been competition among producers to serve the largest clients and an ongoing debate in regulatory arenas about how to prevent small consumers from picking up an inordinate share of the fixed costs.

While the utilities see a gradual trend of increasing competition, nearly all homeowners and small businesses still have one logical choice for gas service -- the historic monopoly provider. The result is a bifurcated market of "core" and "non-core" customers. Non-core customers are businesses that use so much gas that providers will compete for their business, while core customers are those relying on historic providers.

**Transportation fuels.** About half of the energy consumed in the State is used to move people and goods. Californians consume nearly 1 billion gallons of gasoline a month. On a global scale, California is the third largest consumer of gasoline, after only the United States as a whole and Russia.

Gasoline and diesel account for most of the transportation fuel. California's consumption allows both consumers and policy makers to exert significant influence on the market and national policies, such as the reformulation of transportation fuels to pollutants. The market for transportation fuel is for the most part competitive, but inventories and transactions are closely monitored to assess pricing and supply trends that could impact other sectors of the economy.



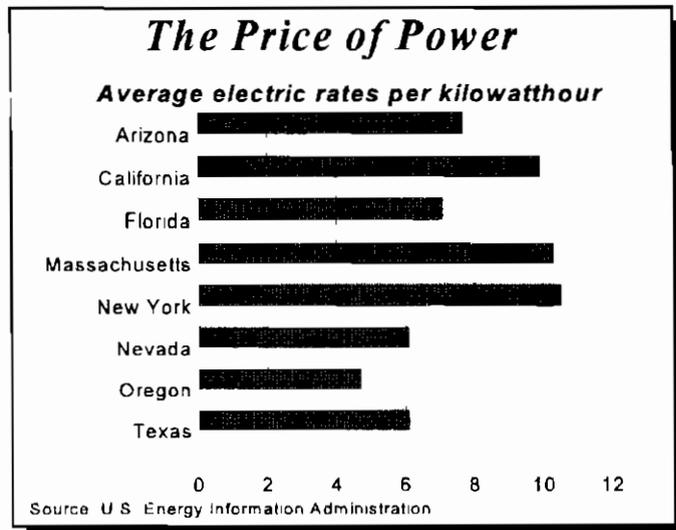
*Gas expenditures make up much of the transportation costs, and large states make up much of the market.*

In the future, the market for electricity, natural gas and transportation fuels are expected to increasingly overlap -- as more natural gas is used to generate electricity and as more electricity is used for transportation. Currently about one-third of the State's electricity is generated from natural gas.

### ***Energy: Endowments, Decisions***

The trends toward competitive utility services and the increasing inter-relationships between fuel sources are common among large industrial states. But individual circumstances influence how states and regions meet energy needs.

The choices policy makers face are a product of what the University of California's Energy Institute refers to as endowments and decisions.<sup>16</sup> Endowments are the natural resources, geography, demographics and other factors that shape the landscape of a region's energy needs and options for meeting those needs. The decisions reflect the choices, based on endowments, that are made by market players and policy makers. Two facts capture the success and failure of those choices: California's electricity rates are among the highest in the nation, but California's electric bills are among the lowest. Among California's energy endowments:



*Electric rates are a product of available resources, regulatory policies and utility decisions.*

- ***California is an enormous energy market.*** While California's per capita energy use is among the lowest in the nation, the market is by far the largest in the nation for electricity, natural gas and transportation fuels. From a policy standpoint, the size of the California market means that state policies -- such as the electric vehicle mandate -- have the ability to shape market factors in the region and nation. Conversely, federal policies -- such as the push toward competitive energy markets -- can have a more profound effect in California.
- ***California's energy demands are growing.*** Because of population and economic growth, peak demand for electricity is expected to increase over the next 20 years by 40 percent and overall energy use is expected to increase by 29 percent. About three-quarters of the higher demand should be satisfied with energy efficiency, but the balance will have to come from increased generation.<sup>17</sup>
- ***Air pollution heavily influences energy policies.*** Pollution control efforts have allowed many urban areas to see air quality improvements despite rapid growth. But major metropolitan areas still have some of the dirtiest air in the nation and efforts to reduce the public health threats without hampering the economy increasingly require coordination among energy, transportation and air pollution agencies.
- ***California lacks cheap fuel sources.*** Unlike other states with large fossil fuel reserves or hydroelectric generators, most of California's energy has to be imported. This fact contributes to the State's high electricity rates and is among the reasons the State has encouraged solar, wind and other locally derived renewable resources.

- **California's mild climate.** The temperate climate of coastal cities minimizes the energy used to keep warm in the winter and cool in the summer. While this results in lower energy consumption per household, it requires utilities to recover fixed costs, such as distribution lines and billing, over fewer energy sales.

Given these endowments, utility managers and policy makers have made decisions about how energy needs can be met while satisfying other economic and environmental policy goals. Among the decisions made in California that have contributed to the State's low electricity bills and high electricity rates are the following:

- **High-cost nuclear power.** Nuclear power plants were encouraged and constructed -- ultimately at greater costs than were anticipated and with higher operational costs than fossil fuel plants. For instance, Diablo Canyon, originally estimated to cost \$500 million, cost \$5 billion to construct.
- **Independent power purchases.** The PUC in the early 1980s required utilities to purchase independently produced power -- most of it from gas-fired cogeneration plants located at manufacturing facilities -- at fixed prices. As oil and gas prices fell, these fixed contracts required the utilities to continue buying power far above market rates. Even without restructuring, these costs would dramatically decline over the next five years as the fixed contracts expire. More recently negotiated contracts allow prices to be adjusted to reflect the current market costs.
- **Inefficient regulation.** The PUC, like some of its peers nationwide, continued to use inefficient cost-plus or rate-of-return rate-making that encourages higher costs and rewards inefficiency. The regulations became even more complicated as the PUC tried to compensate for those shortcomings, usually by layering on additional proceedings. One former PUC staff member called it a "regulatory hydra of well-intentioned proceedings."<sup>18</sup>
- **Efficiency investments.** California, more than other states, required utilities to invest in research and development and conservation. These costs are responsible for 3 percent of the average electric bill.<sup>19</sup> Program supporters assert the lower bills resulting from efficiency gains more than compensate for the higher rates resulting from additional investment. Per capita energy consumption has decreased by 15 percent since 1978.

### ***Behind the Higher Rates***

A review by a private consultant of rates charged by San Diego Gas and Electric Company concluded that two factors are to blame for the utility's rates historically being more than 40 percent above the national average. The largest factor -- responsible for more than half of the above-average rates -- was the region's mild climate, which forces the company to recover its fixed costs across lower than average sales. The second largest factor -- responsible for about one-sixth of the over-average rates -- was the physical inability of the utility to tap the cheapest available sources of electricity.

Some of the factors contributing to the high rates are already easing, primarily as above-market contracts expire over the next five years. In addition, the threat of competition has encouraged the monopolies to find ways to cut costs, and those savings are reflected in lower rates. The largest electricity consumers, however, especially manufacturing facilities sought after by competing states, have not benefited from the efficiency improvements and must endure the higher rates associated with nuclear and other uneconomic generating decisions. The concern over rates paid by the large consumers has provided much of the political impetus to use competition to drive down generation costs. It also has driven the debate toward opening retail sales to competition -- allowing customers to negotiate contracts directly with power producers.

### ***Energy: Electricity Competition***

The genesis of competition in the electricity industry rests in the energy crises of the 1970s. Congress responded to oil shortages, rising electricity costs, and the decreasing efficiencies of large utility-owned generating stations by enacting in 1978 the Public Utility Regulatory Policies Act (PURPA). The law required utilities to purchase power from "Qualifying Facilities," or "QFs." To qualify, the facilities had to use alternative sources of energy or "cogenerate" the electricity as part of another use of fossil fuels, such as a steam generator at a food processing plant. The law required utilities to purchase the power at the "avoided cost" -- that is, the cost the utility would have paid for the next unit of power from a new generator. The law effectively created competition among independent and utility generators.

The efforts by state regulators to implement PURPA were fraught with controversy and are partly to blame for the State's above-average rates. Despite controversies over prices, the policy proved that electricity generation was not a natural monopoly. Many companies using many fuels and technologies can generate electricity provided there is a market in which to sell it. The result: California utilities have more than 600 contracts with independent producers. QFs produce

#### ***How Technology Slew Monopolies***

FERC described how technology undermined the rationale for monopoly power utilities in its 1995 rule promoting wholesale competition among generators:

*In addition to economic changes in the industry, significant technological changes in both generation and transmission have occurred since 1935. Through the 1960s, bigger was cheaper in the generation sector and the industry was able to capitalize on economies of scale to produce power at lower per-unit costs from larger and larger plants.... Scale economies encouraged power generation by large vertically integrated utility companies that also transmitted and distributed power.*

*Beginning in the 1970s, however, additional economies of scale in generation were no longer being achieved. A significant factor was that larger generation units were found to need relatively greater maintenance and experience longer down times.... Bigger was no longer better. Further dictating against larger generation units were advances in technologies that allowed scale economies to be exploited by smaller size units, thereby allowing smaller new plants to be brought on line at costs below those of the large plants of the 1970s.*

nearly 20 percent of the electricity sold by investor-owned utilities in California. They account for more than half of the generation capacity added to the grid since 1982. Even utilities have gotten into the QF business -- selling "independent power" to other utilities and themselves.

As competition percolated through the brick and mortar represented by the monopolies and regulating commissions, the economic foundation and the social compact that was built upon it began to erode. In 1992, Congress pushed the industry closer to full-scale competition by enacting the Energy Policy Act. The act promoted greater wholesale competition by lowering the threshold for new producers to enter the market and allowing greater access to the transmission lines owned by monopoly utilities. The 1992 act also amended the Public Utility Holding Company Act, enabling a new class of wholesale generators to compete for business by exempting them from regulation by the Securities and Exchange Commission.

The 1992 act prohibited the Federal Energy Regulatory Commission from ordering retail competition, but allowed states to create a market where individual customers could buy power from independent producers.

The PUC, recognizing the failure of regulation to deliver low rates, pursued competitive markets at a pace unparalleled in the nation. The decision to move quickly was inspired in part by the experience of natural gas -- in which gradual deregulation delayed the benefits of competition without reducing the unavoidable costs associated with such a transition. The PUC adopted a plan in December 1995 that called on the large investor-owned utilities to petition FERC for permission to create a competitive system. The utilities filed those petitions in April 1996. In August

### ***The Race for Competition and Lower Prices***

The federal Energy Act of 1992 was the starting gun for California's race toward competitive electricity markets.

**February 1993.** The PUC published *California's Electric Services Industry: Perspectives on the Past, Strategies for the Future*, more commonly called the "Yellow Book," in which it conceded the failure of cost-plus regulation and the need to replace regulation with competition.

**April 1994.** The PUC released its *Order Instituting Rulemaking and Investigation on the Commission's Proposed Policies Governing Restructuring California's Electrical Services Industry and Reforming Regulation*, more commonly known as the "Blue Book." The order proposed creation of a competitive wholesale market modeled after the British pool system and a direct access market so large customers could directly choose among generators. The distribution system, which will remain monopolistic, would be governed by performance-based rate-making that would reward utilities for cutting costs.

**May 1995.** The PUC issued two competing proposals: One plan called for generators to sell power into a pool, delivering to utility customers the cheapest available power. The other allowed customers to buy directly from generators. The proposals generated more controversy than consensus over how to proceed.

**June 1995.** A memorandum of understanding was negotiated with the help of legislators and the Governor and signed by most of the major parties supporting a wholesale market with phased-in retail competition.

**December 1995.** The PUC voted 3-2 to back a plan based on the June deal, with minority members offering an alternate plan to accelerate retail competition. One Commissioner said the vote was not a disagreement on how to restructure, but rather: "One plan says go fast and the other plan says go faster."

1996, the Legislature endorsed and refined key aspects of the plan by enacting AB 1890 (Brulte). The legislation set the stage for realigning the State's energy-related organizations.

## *Telecommunications*

Electricity and natural gas service share with telecommunications a history of monopoly providers and government regulation that has come under increasing competitive pressures. Energy and telecommunications utilities, however, are different in some essential ways: Telecommunications services do not have the same environmental impacts as energy services. And energy issues go far beyond the services of investor-owned utilities to include municipal providers, transportation issues, and concerns over energy imports. While telecommunications has become more complex as technology has allowed for competition and new services, the PUC has remained the State's central regulatory forum. The PUC's roles in telecommunications, however, are similar to those in monopoly energy markets:

- ***The PUC sets rates.*** After reviewing and analyzing the expenses and other business decisions of monopoly providers, the PUC sets rates that are fair and reasonable for consumers while providing for a return on utility investment.
- ***The PUC implements public goods programs.*** The PUC developed funding and other mechanisms to satisfy such public policy goals as universal service, which ensures that all segments of society have access to affordable phone services. Similarly, the PUC administers programs that provide hearing-impaired people with devices allowing them to communicate by phone.
- ***The PUC resolves customer complaints.*** While utility customers can try to work out problems directly with the utility, the PUC has informal and formal procedures for settling disputes between the captive customer and the monopoly. The PUC has expanded this role to take in disputes between consumers and competitive service providers within PUC jurisdiction.

The historic focus of the PUC's telecommunications regulation has been 22 local exchange companies that have had exclusive franchises to provide basic service -- dial tone, local calls and access to other services. Pacific Bell, the former affiliate of AT&T, is by far the largest company of the 22 local exchanges. General Telephone of California (GTE) is the second largest provider. There are three "mid-sized" companies -- Citizens, Contel and Roseville, and 17 small companies that serve Californians in such communities as Foresthill, Calaveras, Ducor and Volcano. GTE is in the process of acquiring Contel. When that merger is complete, Pac Bell and GTE will account for 98.6 percent of the access lines in the State.

Besides the 22 local exchanges, the PUC regulates a rapidly growing number of other companies that offer other telecommunications technologies or specialize in services that were once part of the vertical monopolies. Just 15 years ago, the PUC had jurisdiction over 75 telecommunication companies. Today, more than 400 companies fall within the Commission's purview, and competition is just beginning at the local level. Most of the new companies reflect the emergence of wireless technology and long-distance resellers.<sup>20</sup>

### ***Telecommunications: Deregulation***

Like energy utilities, the telecommunications industry is regulated at both the federal and state level. And like energy, the pressure to allow competition in telecommunications was initiated at the federal level. In the 1950s, the Federal Communications Commission began wrestling with applications from companies that wanted to use new microwave technologies to create private communication systems. The applications sparked a debate over whether the telecommunications companies were still natural monopolies, whether the public interest would be served by competition and whether that competition threatened national security by challenging the financial integrity of the nation's (AT&T's) network. In 1969, the FCC finally gave MCI permission to construct a point-to-point microwave link that it could sell to individual users -- providing the first real test of the theory that at least some telephone services were not natural monopolies.

While the FCC dealt with the permit applications and Congress debated the possibility of statutory reforms, the Department of Justice developed an antitrust case and took AT&T to court, arguing that the monopoly had taken illegal steps to thwart emerging competition in aspects of the network that were not true monopolies -- historically in the telephone equipment market and, as MCI was proving, in long-distance services.

In a 1984 consent decree, U.S. District Court Judge Harold Greene ordered that AT&T be divested of its 22 regional affiliates known as "baby bells" and allowed for competition in the long-distance market. The decree left the regulation -- and deregulation -- of local companies to the states. But it also restricted the regional companies from entering the long distance and equipment manufacturing businesses.

The California PUC, following the federal model, has pushed piecemeal toward competition. First regional phone companies were required to allow long-distance companies to access their customers. This required the PUC to determine costs and set access prices for the individual components of the local network, a process known as unbundling. Next the PUC required the local exchange companies to allow competitors to hook their equipment to that of the local telephone companies.

In 1993, the Commission issued a report, *Enhancing California's Competitive Strength: A Strategy for Telecommunications*

*Infrastructure.* The report signaled the PUC's intent to open the balance of the telephone network to competition. The Legislature responded that year with AB 3606 (Moore), which refined and accelerated the Commission's plan to increase competition.

The PUC has attempted to induce competition by requiring existing telephone companies to sell services at discounted prices to wholesale companies that "resell" those services in competition with the local companies. At the same time, the PUC replaced its traditional cost-of-service rate-making with price caps requiring the largest local exchange companies to share with customers profits exceeding established levels. From the consumer standpoint, this evolution allowed for choice -- first in long distance service, then in regional toll calls and soon in local telephone services.

In February 1996, Congress passed the Telecommunications Act of 1996, which addressed policy issues beyond the scope of the consent decree. In the first comprehensive revision of federal law since the 1934 telecommunications act, Congress cleared a path for competition at virtually every level of the telecommunications network.

The PUC maintains that the telecommunications industry provides a preview of how the Commission will function in competitive markets: The intense scrutiny of rate regulation has given way to performance-based rate caps, while its role as a referee among market players and as a protector of the public against unfair business practices has increased.

The PUC also has dealt with new problems: In setting rates, it has tried to sort out which capital expenditures were needed by monopolies to maintain service and which were intended to help the companies enter other markets or fend off potential competitors. It has dealt with privacy

### ***Congress Embraces Competition***

The Telecommunications Act of 1996 made four basic changes affecting the regulated aspects of the telecommunications network:

- ***Requires local competition.*** The law overrules any state laws that limit competition of local phone service. California already had both a statute and a regulatory strategy for allowing local phone competition by January 1996, to allow for resale competition by March 1996 and to open all telecommunications markets by January 1997. The markets, however, are not fully competitive and the PUC plans to continue to regulate local companies because they maintain considerable market power.
- ***Allows regional bells to compete.*** The law allows affiliates of the regional bell companies to enter the telecommunications equipment manufacturing business. It also allows affiliates of the regional bells to enter into the long-distance market once they remove barriers to competition in the local market.
- ***Allows for cable-phone crossover.*** The law allows for cable television companies to enter into the telephone business and telephone companies to enter the cable business. It relaxes rate regulation, particularly where "crossover" competition exists.
- ***Eases ownership rules.*** The law relaxes FCC rules that restricted the ownership concentration of local television stations, national networks and cable systems.

issues in implementing Caller ID and has conducted antitrust investigations concerning cellular telephone companies.

At the local level, the PUC must resolve a number of technical, legal and financial issues before competitors can enter some markets. Among the legal issues it must solve are those involving the sale and resale of telephone services that will be the first wave toward local competition. Among the technical issues are how to provide equal access to switching equipment and how to assign new phone numbers. While the PUC has tried to establish new area codes in ways that do not hamper competition, it will soon need to devise an entirely new numbering system because there are not enough area codes to satisfy the demand for new numbers.

None of these proceedings resemble the PUC's traditional rate cases, in which the monopolies' accountants and lawyers debated expenses with the PUC's accountants and lawyers. Instead, these proceedings involve dozens of parties -- large and small consumer interests, potential competitors and other government agencies. In many proceedings, billions of dollars in potential sales are at stake -- along with the chances for competition to take root and for consumers to benefit from the lower prices that result when competition guides the market.

A large challenge for the PUC is to keep pace with the changing technology and to devise strategies quickly for meeting the policy goals of service reliability and encouraging competition. The technical changes are mirrored by changes in the industry that the PUC must assess for their impacts on competition -- such as GTE's purchase of Contel and the proposed merger of Southwestern Bell Communications and Pacific Bell.

While it oversees the birth of competition in previously monopolistic sectors of the industry, the future role of the PUC is being debated: Do consumers who have long been protected from the price abuses of a single telecommunications provider need the same kind of protection in a market where companies are scrambling for their business? Do competitors need a venue for resolving their disputes? When does potential market power abuse end and competition really begin?

### ***Assessing Competition: Work in Progress***

While 1996 federal legislation paves the way for competition throughout telecommunications, the long-distance market has been open long enough for some assessment. Critics assert that the benefits have been reaped by the largest customers in the largest markets and that AT&T continues to dominate the market.

Three companies -- AT&T, MCI and Sprint -- account for 85 percent of the long distance business. AT&T maintains about a 60 percent market share, just below the level of market concentration that historically prompted government intervention.

And for the most part, rates have stayed near rate caps, suggesting that competition is placing little downward pressure on prices. The experience suggests that competition does not occur by government fiat, and market rules like those set forth in the telecommunications act, may need frequent revision to reduce barriers to market entry.

## Transportation

The PUC has jurisdiction over seven types of public transportation providers. An eighth and largest type -- freight trucks -- will move out of the PUC's jurisdiction in January of 1997 as a result of legislation in 1996.

Currently, the PUC requires each carrier to obtain a PUC permit, and as a condition of the permit they must carry liability insurance and comply with safety requirements. Also in each case, the PUC arbitrates consumer complaints and can take administrative enforcement action against operators who violate the conditions of their permit.

The PUC was created when railroads had a de facto monopoly on transportation and the public demanded that it be protected from the abuses and corruption that stymied industry and commerce. The railroad monopoly was eroded with the development of trucking, passenger buses and airlines. But rate regulation continued until the federal government pre-empted states from economic regulation in the interests of interstate commerce.

Trucking rate regulation, on the other hand, was established at the behest of the trucking industry. Intense competition during the Depression of the 1930s was driving firms out of business and government rate-setting eased those pressures at a time when stability in the marketplace was valued over efficiency.

Deregulation of transportation began at the federal level and

### *PUC-Regulated Transportation Providers*

- 1. Household goods movers.** About 1,200 household goods carriers operate in the State. The PUC sets tariffs, which include maximum rates, rules for estimating the cost of moves, losses, damage claims and carrier conduct. Movers set prices in compliance with the tariff.
- 2. Passenger motor carriers.** There are 200 privately owned passenger stage carriers (buses) with scheduled services and individual fares; 2,227 charter bus companies; about 12 limousine companies; and hundreds of shuttle companies (mostly airport shuttles). Municipal buses are not under PUC jurisdiction. Companies with set schedules and routes file tariffs specifying per-person rates. Companies can make small rate changes without approval, but apply to the PUC to make large changes. The PUC approves most requests for rate changes, but only after determining whether competition exists.
- 3. Freight and passenger rail safety.** The PUC inspects heavy rail systems, such as Union Pacific and Santa Fe rail companies, for compliance with state and federal standards concerning tracks, equipment, operations, signals and hazardous materials. PUC inspectors are trained and certified by the Federal Railroad Administration. Under state law, the PUC identifies sites vulnerable to accidents. It oversees rail worker safety and investigates accidents. The PUC reviews and makes recommendations on rail mergers and track abandonments to the U.S. Surface Transportation Board.
- 4. Transit system safety.** The PUC reviews the safety programs of transit systems, including the San Francisco, BART, Metro Rail, San Diego, Santa Clara and Sacramento light rail systems.
- 5. Water vessels.** Operators carrying passengers or goods for-hire, such as the Santa Catalina Island ferry, must obtain PUC permits and may have to file tariffs.
- 6. Airlines.** Airlines must file evidence of liability insurance, but the PUC takes no other action.
- 7. Hot air balloons.** Operators must obtain a PUC permit and comply with safety and consumer protection rules.

was the first large industry in which Congress became convinced that government regulation of prices was a poor substitute for competition. But while the deregulation effort is more than two decades old, the PUC maintains rate regulation over household goods movers and passenger carriers. And as its economic regulation has diminished, the PUC has increased its role in licensing companies, enforcing insurance requirements, setting and enforcing safety standards and resolving consumer complaints.

### ***Transportation: Legislation***

**I**n 1980, Congress deregulated interstate trucking. In 1994 Congress took the next step by pre-empting state regulation of intrastate "rates, routes and service" of motor and air carriers, except for movers of household goods. The 1994 act left safety regulation of trucking with the states, but did not define what regulatory activities qualify as safety-related.

Many states claim safety is tied to economic considerations, allowing them to require proof of insurance and examine a company's economic viability. Federal policy makers are considering a national liability insurance data base for intrastate and interstate trucking that would pre-empt state authority to require proof of insurance as an operating condition. That data base could become a reality within the next two years.

In California, the Governor responded to the 1994 federal law by appointing a "Deregulation Task Force" to determine how the State could best perform the remaining insurance and safety-related functions. The task force was made up of state officials and industry representatives and chaired by the Secretary of the Business, Transportation and Housing Agency.

The task force had difficulty reaching agreement. The PUC proposed a "one-stop" solution that would consolidate the administrative duties at the PUC. The California Trucking Association wanted all of the functions consolidated at the California Highway Patrol (CHP). And the CHP, while willing to perform the safety functions, wanted the Department of Motor Vehicles (DMV) to do the administrative paperwork related to licensing.

In the end, the task force report recommended giving the safety and licensing duties over all segments of the motor carrier industry, except for household goods movers and passenger carriers, to the CHP. It also recommended the State establish a Statewide Motor Carrier Advisory Committee to deal with long-term plans for improving the safety program.

Among the specific tasks the report assigned to the committee was to expand the new CHP registration program to cover all motor carriers, including those trucks and buses still under PUC authority.

In dissenting comments, the PUC concluded that the only consensus was among the departments within the Business, Transportation and Housing Agency: "The disagreement appears to be a turf battle." Whatever consensus existed when the task force put pen to paper evaporated when the legislation was drafted. At that point, the agency changed its position and supported the concept of splitting the duties between the DMV and the CHP.

In 1996, the Legislature passed AB 1683 (Conroy), which will take licensing authority over intrastate freight motor carriers away from the PUC and give it to the DMV; safety enforcement will transfer to the CHP. During an initial one-year period, the DMV would contract the registration function back to the PUC. The DMV estimates it will need 70 additional positions to handle this responsibility and will give preference for those positions to current PUC staff.

Proponents argued that the measure moves PUC functions to other state agencies that are better suited to carry them out. The CHP already has a terminal inspection program that determines whether freight companies have adequate vehicle safety and driver safety programs. The CHP also believes that an estimated 30,000 truckers who are not enrolled with the PUC will have a harder time avoiding a program administered by the DMV and CHP.

The trucking industry pushed the bill primarily because of the PUC's practice of using trucking fees to regulate other industries. For-hire carriers have paid the PUC a fee amounting to 0.5 percent of the companies' gross profits. Private carriers paid somewhat less. Under the legislation, for-hire carriers will pay significantly less and private carriers will pay slightly more. The PUC has been collecting \$20 million annually in transportation fees, but has been unable to show that it spends any more than \$9 million regulating the industry.

The passage of AB 1683 eased the controversies over trucking regulation. But it also raises new questions about the wisdom of regulating safety and liability of some transportation carriers at the PUC while the same functions are being done by other state agencies for the trucking industry.

## *Investor-Owned Water Companies*

The management of water supplies and water quality embodies a complex set of policy concerns in California. The PUC's jurisdiction is limited to the rates charged by investor-owned water companies. Most of the water delivered to cities and farms in California is supplied by federal, state or local government agencies.

More than 80 percent of the water consumed in California is used on farms. Of the less than 20 percent of the water that is consumed in cities, about one-fifth is provided by investor-owned water companies.

The PUC regulates the rates charged by these companies.

Three other state agencies play significant roles in providing water and protecting the public's interest:

- ***Department of Water Resources.*** The department, which is part of the Resources Agency, has two missions. It is the central water planner for the State, periodically estimating needs and articulating options for meeting those needs. In that capacity, the department encourages water conservation technologies and management practices. Most of the department's resources, however, go to its second mission -- operating the State Water Project, which is second only to the federal government in the amount of water it delivers to local suppliers.
- ***State Water Resources Control Board.*** The water board, which is part of the California Environmental Protection Agency, is comprised of five gubernatorial appointees. The board has quasi-legislative and quasi-judicial authorities that it uses to establish water rights and enforce pollution control laws. It is required by law to protect water quality, balance all of the competing needs for water and ensure water is used reasonably.
- ***Department of Health Services.*** The Department's Office of Drinking Water and Environmental Management enforces federally established health standards, whether the service is provided by a public or an investor-owned supplier.

The State's public and investor-owned water suppliers must comply with the standards and rules issued by each of the three agencies. In addition, the private water companies must comply with the PUC's economic regulations. In setting rates, the PUC breaks down the companies based on their size and applies different procedures to the different classes:

- ***Class A -- more than 10,000 customers.*** There are 13 Class A companies and each company has several service areas or districts where it provides water service. The three largest water companies are the California Water Service Company, with 330,000 customers, Southern California Water Company, with 250,000 customers and San Jose Water Company, with 200,000 customers. Class A companies undergo cost-of-service rate proceedings, but the PUC may establish performance-based rates.
- ***Class B -- 2,000 to 10,000 customers.*** There are seven Class B companies. Like Class A companies, they can seek a rate increase every three years through a general rate case application, or they can receive approval for rate increases through a less formal process called an advice letter.

- **Class C -- 500 to 2,000 customers.** There are 32 Class C companies. They can receive nearly automatic rate hikes tied to the Consumer Price Index, or they can apply for larger increases.
- **Class D -- fewer than 500 customers.** There are 143 Class D companies. They, too, can receive virtually automatic rate increases tied to the Consumer Price Index or can file requests for larger increases.

The investor-owned water companies are not undergoing the competitive forces that are affecting all of the other industries within the PUC's jurisdiction. But they are under pressure to improve the management of the water they supply.

### ***Water Utilities: Pressures to Improve***

All domestic water providers, whether public or private, face two challenges in California. The first is to meet the requirements of ever-increasing health standards and the second is to comply with conservation efforts. The health standards are compulsory. As technology makes it possible to identify smaller concentrations of contaminants in water -- and as research links those contaminants to health problems -- water providers are required to meet tougher standards. Typically that means suppliers must invest in more sophisticated treatment works.

Water suppliers in California also are under increasing pressure to adopt strategies that discourage waste in all years and limit water use to the most essential uses in times of short supply. While the State Water Resources Control Board has the ability to set strict standards for water use, the State relies on a set of best management practices that encourage voluntary compliance with conservation measures. Both strategies, however, create costs for water suppliers that must be incorporated in rates. And to the extent that conservation measures work, water suppliers often must raise rates to cover fixed costs that are then spread out over a lower volume of sales.

The investor-owned companies have voiced frustration that the PUC does not fully understand the requirements being placed on them by other government agencies. They also have complained that the PUC -- preoccupied by the complications of energy and telecommunications regulations -- has not paid enough attention to their cases and concerns.

Some of the biggest problems rest with the smallest companies. Some small companies are adjuncts to rural land developments -- where property owners set up water companies to serve new neighborhoods far from existing urban services.

Over time, some of the systems are poorly maintained and the owners do not seek rate increases because they do not want to go through the

PUC's procedures. As a result, when water quality or conservation standards require additional investments, some companies are not financially capable of making the needed improvements.

An additional concern for future regulators is the possibility that cash-short local governments may opt to privatize publicly owned water systems or to contract out the operational aspects of those systems. The Association of California Water Agencies has noted that privatization could limit customer recourse for resolving complaints against public water providers.

## ***Summary***

The market for each of these utilities and common carriers -- energy, telecommunications, transportation and private water suppliers -- is shaped largely by economic and regulatory forces. The economics are influenced most heavily by the technology that determines the services that can be offered and the potential for more than one provider. The regulations represent politically expressed preferences that constantly refine the overriding public interest. While each of these utilities historically had much in common, the changing economic and regulatory factors are eroding the once-solid common ground.

# Energy

- ❖ *Competition among electric generators and the creation of an Independent System Operator will make some state functions obsolete, while the State will need to take on new roles to nurture healthy markets.*
- ❖ *Energy-related public goods programs will continue in competitive energy markets, but the State will need more efficient and adaptable management of those programs.*
- ❖ *As economic regulation diminishes and performance-based rate-making is refined, the State can consolidate oversight duties and end years of inter-agency turf wars.*
- ❖ *A stronger state energy policy will be forged if involved agencies routinely seek legislative approval for changes and are held accountable annually for progress toward established goals.*



# For Competition's Sake

**Finding 1: As presently constituted, neither the Public Utilities Commission nor the California Energy Commission is well-designed to perform the State functions needed by competitive energy markets.**

The need and political consensus to reform the State's energy regulatory structure is increasing as energy markets undergo fundamental change. The sentiment is well-represented by the testimony of Southern California Edison Company:

*Restructuring the industry without reforming the regulatory process is a recipe for failure, and would represent a decision only half completed. Without regulatory reform, Californians simply will not reap the benefits of restructuring they deserve and have come to expect. In essence, electric restructuring will produce 'stranded regulators' if the State does not reform both the CPUC and the Energy Commission.<sup>21</sup>*

Because of the physical nature of electricity and natural gas and because of their importance to the economy and public welfare, state oversight of a competitive energy industry will be essential. The nature of the oversight agency is framed by two key characteristics -- function and culture. What will the agency do? And how will it respond to inevitable conflicts and unforeseeable issues?

Reforming the State's oversight role requires separating existing functions that will not be needed from functions that will be needed and assessing the competencies and cultures of existing agencies to determine which is best suited to perform the needed tasks.

## ***Obsolete Functions***

The physical network that provides electricity is composed of three sectors: Generation facilities that generate electricity using nuclear, fossil-fuel, solar, geothermal, wind and other sources; transmission lines that transmit electricity from where it is generated to where it is needed; and distribution substations and wires that distribute the electricity to consumers.

The PUC has regulated closely the capital and operational expenses of investor-owned monopolies in all three sectors. The PUC has strived for reliable and safe service to be delivered to customers at fair and reasonable rates and with minimal environmental harm.

The Energy Commission's expertise and responsibilities have focused on generation: calculating the need for additional generation, reducing the need for generation through efficiency gains, encouraging generation technologies that are less polluting and renewable, and reviewing applications for thermal generating plants larger than 50 megawatts.

The plan for restructuring the electrical services industry calls for increasing competition among generators -- some of which are now owned by the investor-owned utilities, some by municipal utilities and some by independent power producers.

The transmission system, which is largely owned by the investor-owned utilities and is regulated primarily by the Federal Energy Regulatory Commission, would become a common carrier of the electricity and be managed by a new Independent System Operator (ISO).

The local distribution system is expected to remain a monopoly in the near term and be provided by the traditional utilities, although there may be competition to provide some distribution-related services.

The emergence of a competitive generation market and the break-up of the investor-owned utilities

### ***The Government as Market***

The PUC's first experience in competitive generation markets came when it implemented the Public Utilities Regulatory Policies Act of 1978.

To encourage the development of independent power producers as provided for by the act, the PUC negotiated and eventually required the investor-owned utilities to sign contracts with independent producers.

The contracts provided the upstart producers with the certainty they needed to obtain low-cost financing by fixing the price the utilities would pay for power for the first 10 years of 30-year contracts.

As a further inducement, the contracts were "front-loaded" by fixing the price for electricity on the Energy Commission's 1982 estimate for the price of oil in 1993 -- \$100 a barrel.

The contracts successfully induced new generators into the market. But the scheme proved to be fatally flawed as oil prices in late 1985 dropped and stayed low for the rest of the decade -- leaving ratepayers committed to paying for above-market-price electricity.

One goal of competitive generation markets is to eliminate the government's role in making market-like decisions that concentrate risks onto ratepayers.

will render some State regulatory functions obsolete immediately. Other functions will become obsolete over time.

In testimony and other evidence provided to the Little Hoover Commission, six general State functions were identified as unnecessary once competitive forces begin to control the price of electricity supplied by generators:

**1. PUC Generation Responsibilities.** The PUC's detailed economic regulation of the generation sector can be eliminated because the expenses and revenues associated with those facilities will be governed by market forces. Any new facilities proposed by investor-owned utilities would be subjected to market pricing and will not be added to the rate base of the utility distribution companies. As a result, the PUC will not have to issue "Certificates of Public Convenience and Necessity" or conduct environmental reviews for new generation plants. The PUC will not have to determine the need for new generation through its Biennial Resource Planning Update or repeat its controversial bidding process for independent generators. Rate cases will not have to include the costs of operating and maintaining generation facilities, or ongoing energy cost reviews. One PUC Commissioner testified that this type of generation-related planning by the State is best referred to in the "past tense" -- leaving it to market signals to determine timing and dimension of generating stations.<sup>22</sup>

**2. PUC Transmission Responsibilities.** While the precise responsibilities associated with the transmission system have not been resolved, the investor-owned utilities are not expected to propose and construct new transmission facilities as in the past. The economic aspects of operating, maintaining or expanding the transmission network are most likely to fall within the realm of the Independent System Operator, with continuing authority of the Federal Energy Regulatory Commission.<sup>23</sup>

**3. PUC Electricity Safety and Reliability Responsibilities.** The PUC's safety and reliability oversight of investor-owned utility generation and transmission facilities can be scaled back and ultimately eliminated as the ISO assumes its duties and as more generation is provided by plants not within PUC control. It will be important for the State to consolidate and coordinate safety and reliability responsibilities, particularly for generation and transmission facilities, to reduce duplication and treat similar market players alike.<sup>24</sup>

**4. Energy Commission's "Load Management" Responsibilities.** The Commission reviews the generation and transmission operations of investor-owned utilities to ensure they are efficiently making use of the electricity grid. This efficiency will be achieved without this oversight as the ISO takes control over transmission operations and competitive pressures push market players to seek every opportunity to lower costs.

**5. Energy Commission's Informational Reports.** The Commission's electricity, energy efficiency, energy technology, fuels and biennial reports, as currently defined by law, will be of little use in a competitive market. These reports were intended to guide government determinations of how much electricity was needed and to explore the alternatives to constructing new generating facilities. That analysis was to provide a basis for the PUC to consider facilities proposed by the investor-owned utilities and for the Energy Commission to perform a "needs analysis" as projects came to it for siting review. Some of the information in those reports will be needed by market players and policy makers. But the types of analysis and the forms for distribution should be geared to the needs of the market and policy venues rather than to the central planning function that the reports previously served.<sup>25</sup>

**6. The Energy Commission's Public Adviser.** The Commission envisions the public adviser becoming a consumer advocate and complaint resolver, functions more appropriately housed elsewhere. The traditional function of helping the public in the process duplicates the Energy Commission's public information efforts and are unneeded if the procedures themselves are streamlined and understandable.

## ***Needs of a Competitive Market***

The promise of competitive markets is to deliver lower prices than those produced by government-regulated monopolies. Competitive markets, however, are complex by nature. Oversight agencies will need real time knowledge of market events and be able to explain trends in response to public and industry concerns. They will need to act quickly, confidently and with a sense of neutrality.

The challenges are large. Today, the major utilities make 200 electricity trades a day. In a competitive market, 1.5 million transactions a day will take place.

In addition to the constant flurry of transactions, the energy market will still be subject to long-term trends of supply and demand. Between 1990 and 2011 the State is expected to gain 4 million new households, increasing energy needs by 29 percent. The demand for peaking electricity -- the power needed for those brief periods of high energy use -- is expected to grow even faster -- by 40 percent over the next 18 years. Accommodating this growth, and replacing older inefficient generators with new efficient ones, will require more generation and transmission facilities to be sited.

The blackouts of the summer of 1996 raised significant concerns about system reliability even before the strains of competition are applied. The costs of blackouts can be enormous and the potential for more in a competitive market has policy makers and consumer groups concerned. The electricity restructuring legislation enacted in 1996 recognized the need to ensure reliability and provided for the creation of standards and

better interstate protocols to improve reliability.

From testimony and other evidence gathered by the Little Hoover Commission, six State functions were identified as needed for competitive energy markets to function well.

### 1. *Consolidated Generation and Transmission Facility Siting.*

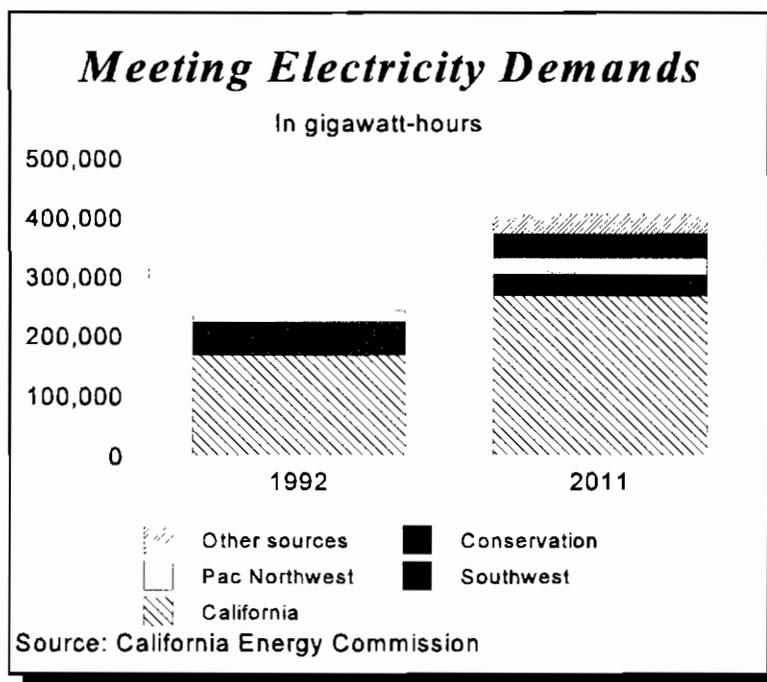
Energy officials have predicted that because of population growth, the early retirement of nuclear plants, the advent of electric cars and a market-demand for cheaper power, California may experience in the near future the first real surge in new generation facilities in two decades.<sup>26</sup> A consolidated and streamlined siting authority is essential to encouraging the investment in new generation that is expected to produce lower-priced power.

While the Energy Commission has an established siting program, the approval process for new transmission lines has been fractured and confused.

Transmission facilities are now reviewed by the PUC if they are proposed by investor-owned utilities. Municipal utility districts can approve their own transmission additions, even if the lines are outside of their service territory. The Energy Commission reviews transmission lines associated with new power plants within its jurisdiction. And there is no clear process for licensing non-utility transmission facilities should any be proposed.

Recognizing the potential problem nationwide, the Keystone Center, a non-profit policy institute, recently completed a model state transmission siting law that closely resembles the Energy Commission's CEQA-like process for siting power plants. The model law was created because of concerns that transmission projects were bogged down in review procedures, adding to costs and creating uncertainty for project planners. If this process was not improved before the advent of competition, the group concluded, customers may not be able to capture the benefits of the market.<sup>27</sup>

The Little Hoover Commission found significant agreement that the advent of competition provided the State an opportunity to consolidate the siting approval processes for generation and transmission. The



*Growth is expected to push up demand for electricity. Some of the new demand will be met with imports and efficiency.*

sentiment is well represented by the Energy Commission's testimony:

*Consolidation of licensing authority for generation and transmission facilities in California is one of the most important steps the Legislature should take to provide evenhanded, fair and effective land use and environmental regulation of a competitive generation industry, thereby enhancing regulatory certainty and process streamlining for all competitors.<sup>28</sup>*

One PUC Commissioner testified that the siting of generation and transmission facilities should be done by the same agency. But another Commissioner testified that the PUC saw itself doing environmental reviews of new transmission facilities as part of its oversight of distribution monopolies.<sup>29</sup>

In addition to efficiency in process, consolidating these authorities would provide a consistent mechanism for the State to apply eminent domain authority, particularly when it is needed to acquire routes for new transmission facilities. Historically, transmission facilities were planned and constructed by investor-owned utilities, which have eminent domain power granted in the Public Utilities Code. Utilities are not expected to play that same role in the future. And if utilities were to initiate transmission additions, eminent domain authority would give them an unfair advantage over competitors lacking that authority.

The siting of transmission and generation facilities will not require the same economic thresholds of past government reviews. But proposals will need to be analyzed to ensure that new facilities are enhancing competition and not discouraging it, and that new facilities are not diminishing the physical reliability of the grid.<sup>30</sup> For those reasons, consolidating the State's siting review with the agency responsible for market power monitoring and system reliability would provide additional efficiency.

The restructuring prompted by deregulation provides the Legislature the chance to achieve a policy goal first set in the Warren-Alquist Act: to consolidate responsibility for regulating electrical generating and related transmission facilities.<sup>31</sup> The siting authority also will continue to be the best place for the State to coordinate the goals of environmental protection and economic development, as was envisioned by the act.

Similarly, the Governor's 1995 energy reorganization plan envisioned consolidating the PUC's and Energy Commission's siting authority into a single agency, which also would have effectively consolidated the authority to site most generation and transmission facilities. That plan, however, was designed without consideration of the other oversight functions that a competitive generation market would need. As a result, it proposed creating a new facility siting board with no other responsibilities to perform that function.

**2. Consolidated Safety and Reliability Oversight of Generation.** In a competitive market, the State will need to consolidate the safety and environmental compliance oversight of generating plants to assure that market players receive equal treatment and that public health and safety goals are met. The Little Hoover Commission was told that federal, state and local agencies now competently perform these tasks, and even appear to coordinate their efforts to reduce overlap and conflicts. The PUC, for instance, establishes safety standards for investor-owned facilities and conducts reviews to ensure that utilities are in compliance. The Energy Commission places conditions on the approval of plants, and then makes sure those requirements are met. Smaller facilities are inspected by county authorities and all facilities must comply with federal and state worker safety laws. While this system may work well now, the agencies and the utilities will change significantly in the future, providing the need and the opportunity to realign these functions. In addition, federal authorities may take on a larger role in this area, preventing the State from performing this function.

In a competitive market, the costs associated with facilities dropping off line will be borne more directly by the investors, creating an incentive for generators to increase their reliability. But there also is increasing concern that the desire to reduce costs will diminish the overall reliability of the system. The Energy Commission already has a Transmission System Evaluation Program and a Generation System Efficiency Program. Where possible the State will want to consolidate this authority, and where the function cannot be consolidated it must be coordinated.

**3. Market Power Monitoring.** The PUC's electricity restructuring plan attempts to minimize the market power of existing monopoly utilities by turning transmission facilities over to an ISO and encouraging the utilities to divest some generating plants. But experts also believe continuous and detailed monitoring for potential market power abuses will be required for competitive forces to take and keep control of prices. The problem, defined by a Harvard researcher, has been detected in a number of industries where competition has slowly found its way into markets previously controlled by a limited number of suppliers:

*As a basic matter, market power signifies an ability to affect the terms of trade in the market. More importantly, however, for the economists' case regarding the damage to society caused by the absence of competition, market power translates into an ability to earn supracompetitive returns, to maintain excess productive capacity, to invest in superfluous advertising and/or to engage in other forms of waste.*<sup>32</sup>

A study of Britain's competitive markets found that the current duopoly is not delivering the prices that would be expected in a more competitive market. However, the existence of a market power watchdog was by itself enough to reduce potential market power abuses.<sup>33</sup> Economists have had a similar experience in telecommunications -- where the

constant eye of federal regulators has appeared to reduce market power abuse even when competition is not vigorous enough to sustain downward pressure on prices.

Monitoring for market power in the electricity services industry will require detailed and constant analysis of transactions, and will require a knowledge of the economic and physical properties that determine the flow of electrons and the flow of dollars. The appropriate response to market power abuse will be varied. In some cases, the solution may be for the Energy Commission to accelerate the applications for new generators or new transmission facilities in order to encourage competition. In other cases, antitrust action may be the best solution. As in other competitive markets, the responsibility for responding to these problems will be shared among different entities, such as the U.S. Department of Justice and the State Attorney General, which both have authority to bring antitrust and related actions against market players

**4. *Gathering and Analyzing Market Information.*** Investors and consumers agree that gathering, analyzing and distributing technical market data by a government agency is critical to market players raising capital and developing competitive strategies and to consumers seeking to make informed consumer decisions. Antitrust laws prevent market players from sharing some critical information, and market data released by individual competitors is always suspect. The testimony from the National Conference of State Legislatures summarized the argument made by many others:

*Companies grow and survive on good information in a competitive market. This role will be even more important if the generation sector operates in a less regulated market. The ability to acquire information about the demand, supply and the ability to distribute or transmit electricity will determine how successful the new competitors to today's utilities can be.<sup>34</sup>*

**5. *Representing California in Out-of-State Forums.*** A competitive market will increase the role of the State in government and industry venues outside of the State's borders -- advocating policy reforms in Congress, before the Federal Energy Regulatory Commission and in the courts. Since California is the largest consumer in the nation, its effectiveness in those venues will be critical to creating and protecting competitive conditions. Historically, the Energy Commission and the PUC have both tried to fill this role, occasionally taking different positions on the same issue. The State's effectiveness in these venues will require a consistent and unified voice, best provided by a single source.

**6. *Registering New Entrants.*** Competitive markets are likely to create a number of new distribution-related players, such as marketers and aggregators. A simple and straightforward registration process is needed to discourage fraud and police unfair business practices. The State's electricity restructuring act of 1996 established this function at the PUC.

## *Core Competencies and Cultures*

The Little Hoover Commission, as it explored the State functions needed in competitive energy markets, was advised by a number of experts to consider how closely the needed functions relate to an agency's historic competencies, as well as an agency's cultural attributes for determining and defending the public interest.

**Public Utilities Commission.** The PUC's core competencies center on the detailed economic regulation of monopolies and the protection of consumers through the design of nondiscriminatory rates. It also establishes and enforces safety and reliability standards to protect workers and citizens in the production and delivery of inherently dangerous commodities. As new issues have arisen, it has developed new regulatory schemes to meet the needs of monopoly investors and ratepayers. For instance, the PUC has infused conservation alternatives into plans for meeting growing energy demands, included research and development programs in the rate base, and established subsidy programs for low-income residents.

While this evolution has required the PUC to develop new skills, it also has created a culture of intense intervention at the PUC. The intervention was done in the name of both the ratepayers and the shareholders, and carried out through a complex and detailed court-like process that built a factual record for Commission decision-making.

Inherent in the Commission's push for competitive markets is a strongly held belief on the part of the PUC's leadership that well-functioning markets will deliver products more cost-effectively than tightly regulated markets.

Specifically, the PUC's culture raises three concerns with potential market competitors: The first is that the PUC will be biased toward intervention into the market. Second, that the PUC will be biased in favor of the former monopolies that it has protected from financial risks. And third, that because of the PUC's large workload and the inability of Commissioners to be involved in the fact-gathering stages of a case, the PUC cannot quickly assess issues and make decisions.

**Energy Commission.** Like the PUC, the Energy Commission was created in response to market failure -- an under-investment in alternative and cleaner energy sources and in efficiency technology. It also was created to clarify State energy policies and consolidate approval of electricity generating plants.

Over the last decade, the Energy Commission has displayed a maturing ability to use market forces to increase energy choices and lower prices, while advancing publicly held environmental goals.

In the mid-1980s, the Energy Commission pushed -- over the PUC's

objections -- for new natural gas pipelines into the State that are expected to save consumers \$5.8 billion over 25 years. More recently -- during the gasoline price spike in the spring of 1996 -- the Energy Commission correctly and quickly identified the causes of the price hikes, reducing political pressure for the State to intervene in the market or ease air pollution requirements that the gasoline industry incorrectly blamed as the reason for the increase.

The Energy Commission has advocated that the decision of whether to intervene in markets be left to the Legislature and the Governor. To counter potential market power abuses the Energy Commission believes the first response should be traditional antitrust laws, with other priority remedies including a lowering of market barriers or State support of transmission additions to increase competition.<sup>35</sup>

The Energy Commission in its 1995 Electricity Report transformed the "needs" analysis it conducts when new generation facilities are proposed to conclude that if a plant is financed completely at the investors' risk and complies with environmental laws it is automatically needed to promote competition.

The Energy Commission's fuels technology branch helped to develop alternatives to gasoline that prompted gas suppliers to develop cleaner burning fuels. The Commission participated in programs that spurred private sector research in home appliance efficiency. And anticipating a competitive electricity market, the Commission is looking for ways to nurture an "energy services" industry as a substitute for government conservation programs.

Like the PUC, the Commission relies on public hearings and plural body decision-making to set policy. But because of a smaller and more focused workload, Commissioners are directly involved in the hearings as well as the deliberations and decision-making.

### ***When Information Is Policy Enough***

One difficult dilemma for free market democracies is knowing when the government should intervene in markets and when it should forgo intervention.

The 1996 gas price spike demonstrated the value of understanding the complexities of the market before intervening in the market. In the first four months of 1996, retail gasoline prices rose from an average of \$1.15 a gallon to nearly \$1.50 a gallon. Oil companies blamed California regulations that required them to upgrade refineries.

Some lawmakers advocated increasing taxes to capture the higher profits being reaped by the oil companies while other lawmakers proposed easing clean air regulations or reducing fuel taxes to deliver lower prices.

The Energy Commission's nearly instantaneous analysis showed that a number of factors contributed to the rising prices -- everything from negotiations over Iraqi oil sales to normal seasonal demand increases. It found that only 6 to 7 cents of the increase was the result of California clean air requirements.

By correctly predicting the market would correct itself, the Commission convinced lawmakers to take no action.

## *Competitive Market Oversight*

Virtually every state energy reorganization effort of the last 20 years has struggled with the central problem of how to align the regulatory authorities associated with the energy monopolies with those associated with the broader energy markets. The move to competitive markets completely reframes this debate. The issue before policy makers now is how to efficiently oversee energy markets that will become increasingly competitive.

Industry, environmental and consumer groups believe a commission rather than a department should provide oversight of competitive energy markets -- to avoid the capriciousness of a department director, to capture the wisdom of a multi-disciplined decision-making body and to create the political stability that markets favor.

The core function of that commission will be gathering the detailed market-related information that is needed for investors and generators to compete, for consumers to make wise decisions, and for law enforcement authorities and policy makers to be confident that competition and not market power abuse or collusion is controlling prices. Most of the regulatory functions will relate to the environmental and technical issues involved in siting and operating generation facilities.

Culturally, the oversight commission will be required to be a neutral decision-maker, treating all market players fairly. Culturally, the oversight commission will be needed to make quick decisions and be focused on the industry. And culturally, the oversight commission will have to be biased against intervention, relying whenever possible on market players to respond to fluctuations in supply and price.

Of the State's two energy agencies, the Energy Commission has more of the core competencies needed to facilitate competition: the ability to gather data on markets trends, its one-stop siting process and its technical energy expertise. The Energy Commission also understands the relationships among energy sources that are becoming more important as electric cars come to market and more electricity is produced from natural gas. And the Commission has demonstrated an understanding of how policies can influence market forces to increase consumer choice and lower prices.

The various interests are as concerned about how the state reorganizes itself as they are about the ultimate shape the state government takes. Some are concerned about distracting the agencies with reorganizing the government when they should remain focused on a restructuring industry. Others are concerned about the government losing expertise or prematurely ending needed regulation.

The PUC's former director of strategic planning, among many others, warned that merging the PUC and the Energy Commission in their

present form would perpetuate the cultural problems of the two agencies. Rather, she urged that the functions of the existing agencies be realigned to reflect the needs of a restructured industry and the core competencies of the existing agencies, and suggested a new structure would emerge from that analysis.<sup>36</sup>

In other words, both commissions need to do what they can do best during the transition to competitive energy markets. After adapting to the new economic landscape, additional consolidation could take place.

## ***Recommendations***

***Recommendation 1-A: During the transition, the Governor and the Legislature should divest the PUC of the obsolete regulatory functions governing generation and transmission facilities.***

The PUC's economic regulation of generation and transmission facilities will not be needed when competition begins and the transmission system is managed by the Independent System Operator, which is now slated for January 1988. The PUC will no longer need to conduct environmental reviews of new generation and transmission facilities, and will not be in a position to monitor safety and reliability of generation and transmission facilities.

***Recommendation 1-B: During the transition to competitive electricity markets, the Governor and the Legislature should divest the Energy Commission of obsolete regulatory and planning functions.***

The obsolete functions known at this time are economic forecasting and needs analysis associated with approving most generating facilities, its load management responsibilities and the periodic informational reports. As competitive markets develop, additional functions may prove to be unneeded, as well. While it is important for the public to have knowledge and access concerning decision-making procedures, there is no need to continue or expand the role of the public adviser to take on additional duties.

***Recommendation 1-C: During the transition to competition, the Governor and the Legislature should assign to the California Energy Commission the new functions needed to make competitive energy markets operate.***

In a competitive electricity generation market, the State will need a consolidated siting, environmental review and safety compliance authority for generation and transmission facilities. The market also will

need refined variations of functions already performed by the Energy Commission -- in particular, the gathering and disseminating of detailed market information, monitoring for possible market power abuses and representing the State in regional, national and international regulatory venues. The Energy Commission also should be given the ability to grant facility applicants the power of eminent domain on a case-by-case basis.

***Recommendation 1-D: The Governor and Legislature should amend the electricity restructuring act of 1996 to assign to the Energy Commission responsibility for enforcing safety and reliability standards concerning the transmission grid.***

The Legislature correctly realized the important role in a competitive market of making sure that a reliable system is maintained. It is unclear at this time how much of that responsibility will rest with federal authorities. To the extent that the State can play a significant role in system reliability, that function should be consolidated with other market-oriented oversight responsibilities. One potential model would rely on the Independent System Operator to make recommendations to the Energy Commission regarding standards, have the ISO notify the Energy Commission of potential violations and have the ISO investigate system failures. The legal authority for setting and enforcing standards, however, would be vested in the Energy Commission.



# A Place for Advocacy

**Finding 2: The Energy Commission's dual responsibilities as an energy regulator and an advocate for alternative energy solutions are not compatible with its new mission of encouraging competition and consumer choice.**

**A**t the time the Energy Commission was created, linking regulatory authority with advocacy programs was seen as the most effective way to influence a highly regulated but highly inefficient market. In more recent years, the Energy Commission's advocacy and regulatory roles have been debated as part of the efforts to defuse turf wars between the Energy Commission and the PUC.

Emerging competition requires that the linkage between regulatory and advocacy functions be reconsidered, along with the long-term need for advocacy programs.

In competitive markets government cannot pick the market solution. It also must be careful about trying to influence the decisions that producers and consumers make.

The PUC describes one of the State's roles in a competitive market as a referee. Some market players have adapted as a mantra that government's role in a competitive utility market is to create a level playing field.

While there is much skepticism about the need for a specialized utility referee -- and concern that one company's level playing field is another company's obstacle course -- the common interest is that the State be neutral in its actions.

## *The Purpose of Dual Responsibilities*

The Energy Resources Conservation and Development Commission was a product of its times. In the early 1970s, environmentally minded policy makers became concerned about the environmental and fiscal fallout of plans to build dozens of nuclear power plants to meet growing electricity needs. At the same time, development-minded policy makers became concerned about increasing delays in approving new generation facilities -- the consequence of 30 different local, state and federal permits required of new facilities.

After several attempts, the Legislature in 1973 passed a bill to create an Energy Commission that would forecast energy demands, assess efforts to reduce that demand through efficiency and provide a consolidated approval process for generating facilities. For environmentalists, the Commission's approval process would provide the energy-based needs test that the PUC's rate-related review of new projects had failed to provide. For project supporters, the plan offered consolidated permitting. The bill was vetoed.

Within months, however, the Organization of Petroleum Exporting Countries, in response to the United States' political policies in the Middle East, cut their shipments of crude oil to the West. Energy prices skyrocketed and shortages spread. At the request of the Governor, a nearly identical bill to the one that had been vetoed was passed by the Legislature. In May 1974 the Warren-Alquist Act was signed into law.

In giving the Energy Commission authority to approve new power plants, the Legislature expected the agency to consider those projects in light of anticipated energy demands, the ability of efficiency efforts to reduce demands, the environmental consequences of new plants and less damaging alternatives. Just as the Public Utilities Commission had been created in response to the failure of the market to economically provide competitive utility services, the Energy Commission was created in response to the failure of the PUC to consider these other policy concerns when approving new plants by the investor-owned utilities.

The Legislature also gave the Energy Commission a range of public purpose programs intended to spur the market to develop those less-damaging alternatives -- ones that were less polluting, less reliant on imported fuels and less consuming of existing energy supplies. The Warren-Alquist Act specifically established four mandates that are the basis for the Commission's organizational divisions:

- 1. *Energy Forecasting and Planning.*** These functions were intended to produce a State energy policy that was established through an open process of determining trends, making projections and assessing options for meeting anticipated energy needs. A natural byproduct of this planning is the creation of a state contingency plan for responding to energy emergencies.

While most of these activities were similar to those often assigned to departments, the Commission has relied on its quasi-judicial authority to develop the policy documents and forecasts.

**2. *Technology Development.*** This function was largely intended to compensate for the market's failure to invest in research, development and demonstration of technologies that would use alternative and cleaner energy sources -- particularly in the area of transportation fuels. This function is similar to ones often assigned to departments.

**3. *Energy Efficiency and Conservation.*** This function was a hybrid of grant and loan programs for making improvements to hospitals, schools and public buildings, research programs and public education programs, and the establishment of building and appliance efficiency standards, which the Commission adopted through its process of public hearings and deliberations.

**4. *Facility Siting and Environmental Protection.*** This function most heavily relied upon the Commission's quasi-judicial procedures to establish a record for making decisions that satisfied a number of environmental, public health and due process laws.

As the Commission has matured, the value of its independent components has become clear -- saving residents money, generating jobs and encouraging the technological innovation that could help solve a variety of expensive policy problems. Some of these accomplishments are also the product of the Public Utilities Commission, which has administered rate-based surcharges for research and development, over time eliminated disincentives to conservation and created incentives for the utilities to invest in efficiency measures.

Efficiency investments, for instance, have saved businesses and residents billions of dollars. From 1976 to 1993, the State's economy grew by 60 percent while energy use grew by only 23 percent. The Energy Commission estimates that the various efficiency efforts have saved the State \$27 billion in the last 20 years. Because of the State's appliance standards, refrigerators now use only one-third the electricity of those built a generation ago. Building efficiency standards alone have prevented the need to build an additional 13 power plants at a cost of \$11.6 billion. Those savings are expected to nearly double during the next 13 years, and could compound even quicker if the standards are revised to include recently developed construction techniques.<sup>37</sup>

Technology programs have made California a capital of innovation. The Energy Commission reports that 30,000 jobs are associated with the \$6.9 billion alternative energy industry. Many of these businesses are pioneering innovations that have strong export potential, adding to the State's position as a global trader.

And alternative energy programs are making it easier to meet other environmental goals. The research, development and commercialization of alternative fuels and renewable energy sources have helped the State to meet energy needs in cleaner ways, reducing the health costs of air pollution and avoiding the costs of stricter air pollution controls. Technological advances continue to bring renewable sources closer to market rates. Wind power, for example, has dropped from 25 cents a kilowatt-hour to between 4 and 5 cents a kilowatt-hour -- nearly the price of the cheapest fossil-fueled generator.<sup>38</sup>

Some policy experts believe the success of these programs is in part the result of Commission oversight. The Energy Commission is thought to be able to more vigorously defend these programs during tight budget times and to insulate them from radical changes in policy in the wake of an election. Other policy analysts, however, argue that these types of programs could be better managed as part of a department, without the time-consuming procedures and conflicting priorities expressed by plural body governance.

As early as 1979, policy analysts recognized the problem created by the Energy Commission's combination of regulatory authorities and program responsibilities. The report to the Joint Committee on Energy Policy and Implementation concluded the regulatory process was compromised by placing Commissioners in charge of "line-item" programs often performed by departments. The report said: "The Warren-Alquist Act has placed the same individual in the impossible dual role of judge and advocate." In addition, the law -- while requiring the Commission to generate electricity forecasts for its plant approval process -- did not give the Commission authority to require applicants to use different fuels or technologies.<sup>39</sup>

The analysis recommended separating the department functions -- such as promotional and educational efforts, research and development programs and proposing efficiency standards -- into a department. It recommended preserving the Commission to perform the pure regulatory functions associated with facility siting and enacting regulations.

In the interim, the Energy Commission's dual responsibilities have been successfully defended as essential to influencing heavily regulated energy markets. As those markets are restructured, the drawbacks associated with the structure become more significant.

### ***More Opportunities***

While significant improvements have been made to increase the efficiency of homes, publicly funded research and development is still finding opportunities to save large amounts of money.

Recent research by the California Institute for Energy Efficiency shows that residential heating ducts "leak like sieves," an associate director of the institute reported in testimony to the Little Hoover Commission:

*Typically about one-third of the energy that flows through residential ducts is lost through leaks. We estimate that this costs Californians more than \$600 million a year.*

Efforts are now underway to develop technological fixes.

## *Separating Programs from Oversight*

Since the Energy Commission was formed, energy-related markets have undergone significant changes: Oil prices have dropped and remained low. Electric cars have advanced as a possible alternative to gasoline-powered fuels. Market forces and regulatory reform have encouraged natural gas exploration and development. Technology is encouraging smaller and more efficient electricity generating stations. These and other changes raise four issues about the validity of the Energy Commission maintaining its advocacy responsibilities while assuming oversight of the competitive market.

**1. *Linkage Encourages Intervention.*** The Energy Commission cannot be a light-handed effective oversight agency if it also is responsible for programs intended to influence market choices. The value of a remade Energy Commission will be the ability to -- reliably and without bias -- aggregate confidential market data, administer a one-stop siting process and identify areas where prices are not set by competition. In other government arenas, policy makers have recognized the importance of separating regulatory roles from promotional roles. The Nuclear Regulatory Commission was created to separate the federal regulatory and promotional roles concerning the nuclear power industry. The Federal Aviation Administration is under fire today for putting its promotional duties ahead of its regulatory duties in airline safety.

**2. *The Original Rationale is Diminished.*** The fundamental purpose of linking a siting authority's "needs analysis" and development of alternative technologies will be obsolete in a competitive generation market. The Energy Commission already has recognized that its siting process should not include the classic needs analysis, eroding the original rationale for linking the siting authority with the advocacy function.

**3. *Federal Funding is Declining.*** The funding for many of the Energy Commission's grant and loan programs came from the federal Petroleum Violation Escrow Account, comprised of fines assessed oil companies that overcharged customers during the energy crises. Those funds are declining, requiring a reassessment of state programs funded by them.

**4. *Need for Programs May Change.*** Competitive markets will likely yield different "failures" than regulated ones, maybe even fewer ones -- changing and maybe reducing the need for the Energy Commission's public purpose programs. No one knows for sure what market failures will exist in a competitive market -- whether private research will hold out the same rewards as it does in the computer business, or whether consumers will be willing to pay more for "green" power. A remade Energy Commission will play the critical role of identifying market failures as well as market abuses. But the task of responding to those failures should in most cases be left to others -- such as the Attorney General in

antitrust matters, the Governor and Legislature when new policy issues arise, or a department when research and development might spawn a market solution.

As competitive utility markets develop, policy experts are concerned about the need for the state to maintain funding levels for research into efficiency and alternative fuel technologies. The Energy Commission testified that given the limited rewards of research and development for private companies in competitive markets, the State should rethink its role:

*Consumers will clearly lose in the long-term if government does not find a way to ensure that "public goods" research and development in a collective and coordinated fashion replaces the utility-sponsored research and development that has done so much to advance electric industry technology over the past several decades.<sup>40</sup>*

The electricity restructuring act of 1996 continues the surcharges placed on investor-owned utility bills for research that has been conducted under PUC oversight. The act will generate \$62.5 million a year through 2001. The funding for projects related to transmission and distribution will be allocated by the PUC. Funding for projects related to generation will be allotted by the Energy Commission.

Two-thirds of the Energy Commission's budget already represents pass-through funds -- money from state or federal sources that the Energy Commission passes through to other agencies, nonprofit groups or private companies that qualify for loan and grant programs. Advocates of a department structure have raised convincing arguments that the ministerial duties associated with these programs can be more efficiently performed by a department.<sup>41</sup>

Those concerns, along with the advent of competition and the need to reorganize the Energy Commission and the PUC, provides the State with an opportunity to reassess the governance, scope and goals of the State's public purpose energy programs.

### ***Mergers that Missed the Mark***

While previous reformers have suggested merging the Energy Commission and the Public Utilities Commission, the National Conference on State Legislatures (NCSL) reports that two states that recently merged the two functions, Michigan and Minnesota, have experienced negative results.

In the case of Minnesota, an energy office of 150 people was first merged with the economic development agency and then moved to the State's Public Service Commission. The long-term view stressed by energy planners has lost out to the short-term concern of controlling costs. The energy office staff was reassigned to rate cases and laid off to balance budgets. NCSL concluded: "The long-term voice on energy policy was effectively silenced."

The experience in Michigan was similar, and according to NCSL the office is being moved back to the Department of Commerce where it was before. NCSL concluded:

*In general, the emphasis of Public Service Commission activities -- the rate case at hand -- is much greater than long-term energy planning.*

Other states, responding primarily to the decline in federal funding, are consolidating energy programs into other departments that administer grants and loans or encourage business development. According to the National Conference of State Legislatures and the California Research Bureau: 11 states have the energy-related programs in economic development offices and nine have them in the resources department. Seven states have stand-alone energy offices, not including California, which is the only state with a stand-alone commission. Seven other states have their energy office in the housing agency. Five states have the energy function combined with the PUC.

According to a 1995 survey, 56 percent of the state energy offices expected their budgets to shrink over the next five years.<sup>42</sup> Some offices already have shuttered their doors, including New York's, which was replaced with a research and development financing authority.

## *Public Purpose Programs in the Marketplace*

The role of government in the energy industry is premised on the need to protect environmental values, particularly those related to air pollution and public health and safety, and the need to guard against marketplace abuses of collusion and other unfair business practices in the provision of an essential service. When a large portion of the energy industry, the utility sector, was dominated by monopolies and their regulators, the level of government intervention in the market was high. Little distinction was made between State's regulatory and advocacy roles.

In a competitive market, the distinction takes on greater importance. The director of the University of California Energy Institute described the values of -- and distinctions between -- effective public goods programs, such as investment in new technologies, and the need for effective government oversight.

*There is a clear argument for government supporting research and development of technologies and energy sources due to the public good value of the knowledge that such research produces. The argument for direct government intervention in the generation market, however, has not been made convincingly.*

*Certainly society should be concerned that alternative generation technologies will be available as the supply of fossil fuels declines and their prices rise. Like nearly everyone, I would welcome a low-cost, non-polluting, renewable energy source. Yet I think there is a reason for concern that direct intervention in the generation market will result in subsidies for technologies that will be obsolete before they are needed.<sup>43</sup>*

Consumer groups approach this issue from a different perspective, but have similar concerns. They favor efficiency investments provided they

yield cost-effective benefits to customers. But they also are suspicious of continuing the same institutional arrangements when the market structures dramatically change. The consumer group Toward Utility Rate Normalization (TURN) testified:

*One area that may be ripe for a reduced utility and regulatory role is demand-side management, including energy conservation and related services. The funding and administration of these programs should be removed from the utilities and vested in an independent administrator that would award ratepayer-derived funds on a competitive bid basis to service providers.<sup>44</sup>*

Prior to the legislative action in 1996, a PUC-sponsored working group was exploring a new governance structure for administering research money: the California Energy Research Institute would be sponsored by the University of California and governed by a board made up of academic experts, public officials and representatives of customer groups. Supported by a small staff, the institute would solicit applications for research proposals and award grants.

After the legislative action, the University of California proposed creating a Joint Powers Authority involving the university and the two commissions to coordinate the allocation of research money. The university believes the plan would provide accountability and flexibility.

Likewise, the Energy Commission believes that in a competitive market the State will want to reconsider the organizational structure for collecting and allocating research dollars. The Energy Commission advocates a structure that would capitalize on the accountability of a public organization and the flexibility of a private one.

The Governor's energy reorganization plan reviewed by the Little Hoover Commission in 1995 was designed to consolidate energy-related programs in a department framework. The department, it was argued, was a better venue for modifying these programs as funding and other conditions change. The assessment that those functions

### ***Advocacy vs. Neutrality***

The Energy Commission in recent years illustrated the value of having a government agency playing a research and advocacy role. Through a variety of technology development and demonstration programs, the Commission proved that methanol was an acceptable alternative to gasoline as a transportation fuel. First it showed it was technically feasible, then economically comparable, and then in terms of air pollution, environmentally superior.

The Energy Commission's work allowed the Air Resources Board to establish clean air regulations based on the performance characteristics of methanol. The regulations required the gasoline producers to develop formulas that were at least as clean as methanol -- which they at first maintained was impossible, but ultimately achieved for less than 8 cents a gallon.

The Energy Commission, however, came under increasing fire for advocating methanol in violation of its official policy of being "fuel neutral."

The events demonstrate the value of government research in pushing industries toward the greater public interest, and the importance of separating that advocacy role from the neutral regulatory role.

would be better managed by a department are still sound. The designers of that plan, however, did not have the benefit of knowing which oversight responsibilities would be required in a competitive market and which agency should be responsible for those functions.

Rather than creating a new government agency, which takes considerable time and resources, the evolution of an existing agency to fill this role is more appropriate. The Department of Conservation is vested with a broad range of environmentally and energy-related responsibilities, including the regulation of oil, gas and geothermal wells, and other mineral extraction activities. It implements the surface Mining and Reclamation Act, does geological hazard assessment, administers farmland and other resource conservation. The department would be a logical venue for the Energy Commission's public purpose programs.

The task of a remade Energy Commission will be to facilitate the market: by handling siting applications uniformly and efficiently, providing technical information to all market players and monitoring for market abuses. Its goal is a market that puts a constant downward pressure on prices.

It is still in the State's best interest to maintain the Commission's other functions that have induced investment in alternative fuels, new technologies and conservation measures. These programs have kept a constant upward pressure on efficiency and diversity.

## ***Recommendations***

***Recommendation 2-A: The Governor and the Legislature should transfer from the Energy Commission to the Department of Conservation the public purpose programs concerning transportation fuel research, business development, public education and market transformation programs, including the setting and implementation of building and appliance efficiency standards.***

Placing these functions in a department will make two significant reforms: It will separate advocacy from oversight and it will enable more significant changes in how the programs operate to reflect new funding and market needs. At the same time, the move would preserve the important functions that have saved Californians considerable amounts of money and facilitated the advancement of other energy-related public policies, including clean air and responsible use of other resources.

***Recommendation 2-B: The Governor and the Legislature should amend the electricity restructuring act of 1996 to consolidate the administration of energy research and development programs in the Department of Conservation. The department should establish a broad-based advisory panel to set funding priorities, review applications and advise the department director on allocations.***

The advisory panel should include key legislators, representatives of environmental and consumer groups, the home building and manufacturing industries. The director of the department should be instructed to explore other institutional arrangements for managing the research program, including a joint powers agreement involving energy policy officials and representatives from public and private universities.

# PUC's Diminishing Role

**Finding 3: The PUC, while it will play a transitional role in nurturing competition, could jeopardize the success of the energy restructuring plans if it were to assume oversight of the competitive aspects of energy markets.**

The Public Utilities Commission envisions itself continuing its rate regulation of monopolies, performing a variety of tasks essential to developing competitive markets and taking on the state functions associated with a competitive market.

The PUC vision was based in part on an assessment of what functions would be required of the State as the investor-owned monopolies were broken apart and competition was induced among generators. The PUC saw itself as the natural heir to these functions -- following the monopolies into the marketplace.

The State functions required by more competitive energy markets -- and the Little Hoover Commission's conclusions that the redefined Energy Commission is best suited to assume those duties -- are described in previous findings. Assuming those recommendations were followed, the PUC would continue to have critical tasks -- in the transition to competitive energy markets, in redefining rate regulation of remnant monopolies and in facilitating the evolution of distribution services.

How well those challenges are met will greatly influence the success of the policy choice to replace regulation with competition. How that competition unfolds will, in turn, shape the ultimate structure of the State's energy oversight agency.

## ***The PUC Vision***

The Public Utilities Commission has sought to establish its own role in future markets through its electricity restructuring policy decisions and its Vision 2000 process. In both efforts, the PUC did not seriously consider the role of any other state agency in facilitating competition, providing market oversight or protecting consumers from unfair business practices. The PUC also did not seriously consider any significant changes that should be made to the Public Utilities Code or other statutes.

Commissioners have stated that they see the PUC playing a smaller regulatory role in future energy markets. They acknowledge that much of the PUC's economic regulation will have to be transformed, simplified or eliminated to match the needs of a competitive market.

But the PUC also sees itself taking on competition-related functions, such as monitoring for possible market power abuses in the generation market. And it sees its mission of protecting captive customers from monopoly abuses naturally evolving into protecting consumers from the perils of aggressive marketing.

The PUC -- in its Vision 2000 plan, its industry restructuring policy decisions and in testimony to the Little Hoover Commission -- described the functions it plans to perform during the transition to competitive markets, in the long-term distribution market and in the long-term competitive market. Among them:

### ***In the Transition ...***

The PUC will collect and administer the Competition Transition Charge used to reimburse utilities for investments that will be rendered uneconomic by the advent of competition. Because of the PUC's extensive involvement in regulating the expenditures of the investor-owned utilities, it is well equipped to accelerate reimbursement for those investments through the transition charge fashioned under its restructuring decision and refined by the Legislature in the electricity restructuring act of 1996.

The PUC also will work with the Federal Energy Regulatory Commission (FERC) and others to create the Independent System Operator and the Power Exchange -- two new institutions that will handle the financial and electric transactions of the new market. Some of the most important regulatory decisions on the path to competitive electricity markets are being made by FERC, based on applications by the investor-owned utilities, at the behest of the PUC. The PUC, in its policy decisions, and the Legislature in its restructuring bill, established parameters for those new institutions.

### *In the Long-term Distribution Market ...*

The PUC is establishing and refining performance-based rate-making procedures for the distribution monopolies. California is following a national trend by seeking to replace inefficient rate-of-return regulation with a system of incentives intended to hold down utility expenditures while meeting minimum service standards. The goal is to create a rate-making structure that provides incentives for utility managers to improve service and hold down expenses rather than trying to justify expenses to increase revenue.

The PUC also will be registering new entrants. The electricity restructuring act of 1996 refined the PUC's plans to register marketers and other new service providers as a way of protecting consumers from fly-by-night companies.

Similarly, the PUC will protect consumers from over-aggressive marketing. The PUC, using its experience in telecommunications competition as its guide, envisions overzealous marketers tricking customers into switching service providers. As in telecommunications, the PUC is preparing to enforce marketing standards.

### *In the Long-term Competitive Market ...*

The PUC envisions itself remaining a dominant venue for making state energy policies. The PUC has correctly recognized that its restructuring and similar decisions radically shape state energy policy -- and certainly more than the policy recommendations made by the Energy Commission or the funding decisions made by the Legislature. The PUC sees its role in situational policy making continuing as monopoly markets yield to competitive markets.

The PUC sees itself as a watchdog against market abuses. The PUC -- in concert with federal authorities -- plans to monitor the incumbent utilities, which they regulate, and new independent producers, which they do not regulate, to make sure they are not manipulating the market.

The PUC also envisions a continuing role in serving as the State's ambassador and negotiator in venues outside of the State. The PUC believes it will need to work with the Federal Energy Regulatory Commission, the Congress, and a variety of regional forums to protect the State's interests in generation and transmission matters that will influence the competitive market.

The PUC sees a need for the State to resolve disputes between market players and it believes it is best suited for that role. The PUC believes that to facilitate competition it should take on a role as a referee among competitors to resolve disputes that otherwise might end up in court.

## *The PUC's Critical, But Diminishing Role*

Some of the functions the PUC plans to perform are essential to establishing competitive markets. The PUC, for instance, has pioneered the policy debate and brokered the specific plan with the investor-owned utilities to break up the monopolies and create the institutional framework for making electricity transactions. The Legislature, other state agencies and the market players all see the PUC as uniquely suited for implementing that strategy.

In assessing the long-term role for the Public Utilities Commission, however, policy experts, market players and consumer advocates have differing views on the PUC's appropriate role -- particularly its role in the competitive aspects of the market. Among their concerns:

- ***PUC's Bias Toward Intervention.*** A number of market players testified that the PUC lacks the restraint to forbear from intervening in the market. And while consumer interests have legitimate concerns about the PUC prematurely ceding control over remnant monopolies, the experience in telecommunications and transportation supports the view that the PUC will continue regulation after it is in the best interest of consumers. This concern is supported by the PUC's broad definition of market power abuse as any "unfair treatment of consumers by any of the firms operating in a competitive market."
- ***PUC's Bias Toward Investor-owned Utilities.*** Independent energy producers and municipal utility districts, which have never been regulated by the PUC, fear that the PUC will continue to protect the economic viability of the former monopolies when resolving disputes between competitors. That fear was bolstered in part by the PUC's position that investor-owned utilities should be reimbursed for 100 percent of their investments that will be stranded by the switch to competition.<sup>45</sup>
- ***PUC's Slow Decision-making.*** The PUC's overwhelming workload will make it difficult to swiftly respond to issues. As the issues before the Commission have taken on the complexities of competitive markets, the PUC has not been able to decide cases quickly enough for new entrants.

These issues raise significant concerns about the PUC's ability to evolve from a heavy handed, interventionist economic regulator into a nurturing and neutral parent of competitive markets -- particularly when there is no agreement that any state agency should take on some of the functions the PUC plans to assume. Pacific Gas and Electric Company testified:

*Although under certain circumstances, the CPUC now has an obligation to oversee the maturing of the competitive electricity market, we question whether this is the proper role for the PUC.*

*While certainly it is important to ensure that all participants in the market are able to compete on an equal footing, it is not clear that the CPUC has an expertise to regulate the competitive arena, nor is it clear that the CPUC has the authority to effect any remedies for violations which have been deemed to have occurred. On balance, we believe that the CPUC may not be the proper place to house this market referee function.<sup>46</sup>*

Rather than assuming the market will fail and providing the PUC with the tools for rapid intervention, the utility advocated a structure that would minimize government intervention of any kind to when the market "clearly fails."

The PUC is well suited to retain and refine some critical functions, at least in the near term -- all of them revolving around the break up of the vertical monopolies and the evolution of the distribution market where a horizontal monopoly is expected to remain.<sup>47</sup> But how well the PUC executes these functions will depend in part on whether the PUC tries to take on new functions, or tries to hold onto functions that are no longer needed or could be better performed by another agency. Among the challenges facing the Public Utilities Commission:

**Performance-based rate-making:** Between 30 and 40 percent of a customer's bill pays for distribution-related services -- nearly twice the costs associated with generating the electricity in the first place. As a result, the ability to control distribution costs will have a large impact on energy prices. The PUC's plan to control those costs with performance-based rate-making (PBR), however, may be more complicated than expected.

The PUC in August 1994 adopted a performance-based rate for San Diego Gas and Electric Company that critics say worked out better for the utility than for ratepayers. In the plan's first year, critics say San Diego Gas and Electric achieved \$55 million in before-tax cost savings -- \$32 million in additional after-tax profits. The utility received \$7 million for improving its quality of services, while ratepayers benefited by \$1.1 million.<sup>48</sup>

The consumer group Toward Utility Rate Normalization (TURN) believes the PUC will have to make significant revisions to its performance-based regulations before they simultaneously will protect consumers and shareholders. TURN testified:

*PBR represents far more untested theory than successful practice. Many of the experiments with PBR that have been conducted to date have turned out to be unmitigated disasters from the consumer perspective.... TURN submits that it is far too early to assume that the traditional regulatory role will somehow be dramatically reduced through the magic of PBR.<sup>49</sup>*

**Unbundled distribution services.** One task of the distribution oversight agency will be to “unbundle” the distribution-related services to encourage the development of competition and further reduce the inefficiency of monopoly regulations.

Real-time metering might allow some customers to capture savings from off-peak energy use, and create a niche market for companies that will help consumers achieve this savings. New associations are expected to emerge to aggregate the energy demands from a number of customers and give them more leverage to seek lower rates.

New technologies are expected to expand the opportunity for self-generators, who might then sell power and buy it, and companies will form to facilitate those transactions. Low-income assistance programs now performed by the utilities could be done by government agencies or nonprofit community groups.

The California Energy Institute testified that the State will need to take an active role in encouraging the technologies needed for customers to reap the benefits of competition that may occur at the generation level, but will be experienced by consumers at the distribution end.<sup>50</sup>

One Energy Commissioner asserted it will take an “extensive government effort” if the distribution system is going to evolve from one where a regulated monopoly provides all of the distribution-related services to one where private companies or community groups compete for all energy and social services but for maintaining the line delivering electrons.<sup>51</sup>

**Resolving complaints.** The Legislature in 1996 affirmed the PUC’s plan to take on the role of registering new entrants into competitive electricity markets and resolving consumer complaints that the PUC expects to arise from over-aggressive marketers.

But the Legislature acted after considerable debate about whether the function is needed, and whether it is needed over the long term. The consumer group TURN, in advocating that the PUC take on the role, recognized the harm that could come if in the name of protecting consumers, the PUC regulated too much. TURN testified:

*The objective should not be to create barriers to entry into the business, but rather to assure that consumers who are used to purchasing solely from a regulated monopoly are not abused by unscrupulous operators in the newly opening marketplace.*<sup>52</sup>

Eventually, however, consumers will be used to selecting energy suppliers. And unless the unscrupulous operators are more prevalent in energy than in other businesses, the State will be able to rely on existing law enforcement mechanisms. In addition to these known challenges, complex and unpredicted issues will likely emerge and require resolution.

## *The Complications of Uncertainty*

In looking to see how these issues will play out before the PUC, investor-owned energy utilities have examined how the Commission resolved similar issues in opening telecommunications markets to competition. That history concerns them.

Their overriding anxiety is that, left in a position to regulate, the PUC will regulate. More specifically, they are concerned that the slower and more ad hoc the deregulation process, the more revenue will be earned or lost in the regulatory venue rather than the market place. San Diego Gas and Electric Company testified:

*If the history of telecommunications deregulation provides us with any perspective of where energy regulation is headed in California, we should all have cause for concern. Despite the past decade of so-called telecommunications deregulation, there is not now, nor will there be in the foreseeable future, real or fair competition among suppliers. Instead new entrants are using the regulatory process to their competitive advantage.<sup>53</sup>*

On the same issue, TURN has the exact opposite concern: that deregulation will happen faster than competition -- and that organizational restructuring will happen before the interested parties understand and can agree upon the role of the government:

*As long as the distribution utility remains the only readily available source of electricity for most small consumers, there will be little opportunity for reducing or eliminating the role of the regulator in this portion of the market.<sup>54</sup>*

No one can say for sure how the market will develop for average consumers. While marketers may be as aggressive as in the long-distance business, the retail market at the residential level may develop slowly.

In the case of natural gas, most smaller users have seen the benefits of competition at the wholesale level without having the experience of retail competition. The PUC's role has been to fashion rules that allow for retail competition for large consumers, to ensure that smaller consumers are not stuck with an unfair amount of the fixed costs, and to develop performance-based rate-making to reduce the inefficiencies of regulation. While retail competition is legal for all classes of customers, and may be percolating down to smaller consumers, the transition to competition has been slow.

Southern California Gas, which has undergone a slow and lurching march toward competition, articulated the need for a more strategic regulatory retreat on the part of the PUC in all of these markets:

*In order to fully capture the benefits of restructuring, the regulator must actively measure competition in the various energy market segments and determine when adequate competition exists. The agency should issue a rule-making order with general guidelines for judging utility markets to be "competitive," then work with parties on a case-by-case basis to further refine the definitions. Once a finding of full competition is made, oversight and audit of utilities' management decisions relative to serve those markets should be discontinued.<sup>55</sup>*

One of the most difficult chores facing the PUC will be to determine when it should stop doing what it was created to do. One of the best ways to accomplish that will be to establish rules to determine when competition exists and eliminate regulation as that occurs. And as the regulator retreats, the prevailing public interest can be re-examined and the government's role can be reassessed.

One former PUC Commissioner warned that it will be too easy for the PUC to take on a different role in the market rather than a smaller role:

*The key is to design even more aggressively for the future by setting out specific milestones for specific regulatory withdrawal, and accepting the fact that there is no such thing as perfect regulation, just as there is no such thing as perfect competition.<sup>56</sup>*

Great attention has been paid to the actions government will need to take in the transition to competitive markets and the role of government after competition arrives. The difficulty is knowing specifically when the sun will set on the monopolies and rise on a new market. One consumer advocate quips that the transition is the foreseeable future and the long-term is the unforeseeable future.

The local distribution services provided by investor-owned monopolies are expected to remain fundamentally monopolistic for the foreseeable future. In that sense, the need to regulate rates charged by these companies is the only direct descendent of the PUC's current authorities.

It is tempting to immediately consolidate all energy-related regulatory functions in one agency. But to do so would jeopardize potential market efficiencies worth billions in return for potential government efficiencies worth millions. It will take an extraordinary effort by the PUC to administer the competition transition charge, oversee the divestiture of generation by the investor-owned utilities, institute performance-based rate-making and unbundle the distribution monopoly to invite competition into that sector.

Moving those responsibilities to a new agency in the middle of implementation would jeopardize the success of those efforts. And to make firm decisions now on the State's long-term role in the distribution sector would invite error.

However, it appears that after the PUC implements new regulatory strategies and after market forces have been brought to bear on distribution services, oversight of that sector could be transferred to the same agency overseeing the generation and transmission aspects of the industry. Similarly, oversight of natural gas would be more portable once performance-based rate-making procedures are refined.

## ***Recommendations***

***Recommendation 3-A: The Governor and the Legislature should enact legislation establishing benchmarks and a time line for delineating when and how the PUC will eliminate economic regulation of competitive aspects of the market and when and how it will encourage competition for distribution-related services.***

While the Legislature should expeditiously divest the PUC of functions that will be obsolete with the advent of competition, other regulatory functions will become obsolete over time. Thresholds should be established in statute ahead of time determining when the PUC will cease regulating in a given arena. The benchmarks also will serve to better coordinate activities between the Energy Commission and the PUC.

***Recommendation 3-B: After the transition -- after all customers have access to competitive electricity providers and performance-based rate-making is instituted for distribution monopolies -- the Governor and the Legislature should transfer the PUC's remaining energy-related functions to the Energy Commission.***

The goal of the State should be a single agency with energy oversight authority. But the State should pursue this goal in a way that does not jeopardize emerging markets or compromise consumer protection. The first step is to consolidate those new functions over the expanding competitive market into a single agency. The second step is to consolidate the regulation of remnant energy monopolies at the Energy Commission. The precise timing and scope of the government restructuring will depend upon market developments. But the transfer will be smoother after performance-based rate-making has been refined and it becomes more clear which aspects of the distribution market will remain monopolistic. In any event, establishing rates for the distribution market should be a simple and limited task compared to the PUC's historic role in regulating every aspect of a monopoly power provider.



# Coherent Policy Making

**Finding 4: The State has a fractured and confused process for setting energy-related policies that results in conflicting public efforts with no clear venue for resolving the conflicts.**

The legendary conflicts between the Energy Commission and the PUC are a consequence of competing venues, competing missions, and an unnatural segregation between policy making in the abstract and policy making in everyday decisions of governance.

Many conflicts of the past will not be repeated as the Energy Commission and the PUC stop the regulatory proceedings that attempted to make the supply-and-demand decisions of the market place. But both agencies continue to have different goals for the State and different views for their own future. Not surprisingly, the two conflict.

The first three findings and resulting recommendations of this report would clarify the roles these agencies will play in the future, reassign functions based on developed expertise and contemporary needs and prevent unnecessary conflicts between the two.

Beyond the history of the two agencies, energy is so integral to the economy and a number of environmental and resource issues -- from transportation to air and water protection -- more than one public agency always will impact the formation and implementation of energy policy.

As a result, the State has both the opportunity and the need to establish a policy-making framework that is more accountable and effective, and that provides a clear and timely response to public concerns.

## *A Fractured Process*

Few places in the statutes of California has the Legislature created such a specific policy-making process as in energy, and in few subject areas has there been as much conflict and confusion about who should set policies.

In its authorizing legislation, the Energy Commission was instructed to prepare every two years what the law calls the "Biennial Report." Beginning with Section 25309 of the Resources Code, the law provides specific instructions for preparing the report. The core of the document is the Energy Commission's projection of the State's energy needs over the next 20 years, the alternatives for meeting those needs, and the Energy Commission's recommendations for how those needs should be met. The law provides for the report to be submitted to the Governor. The Governor is required to review the plan and forward it, along with his critique, to the Legislature. In that transmittal, the document is deemed "the official statement of energy policy."

In addition to the "official" policy, the Energy Commission, the Public Utilities Commission, the Air Resources Board, the State Water Resources Control Board, the Department of General Services and a number of small agencies make decisions that effectively set energy-related policies. These situational policies have been particularly important in the case of the PUC -- which in setting rates, approving utility expansion plans and establishing public programs dramatically shapes how the State's energy needs will be met. The Secretary of the Resources Agency described the problem in a legislative hearing as poor coordination:

*While all of the people who work at these different specialty agencies recognize that their set of problems are not the only problems the State must address, they have no mandate to work together within a common policy and regulatory structure to identify and achieve a "low-cost solution" that simultaneously does the best job possible on each of the problems while allowing consumers and businesses to have reliable low cost energy supplies that they need to thrive.<sup>57</sup>*

While the current discussion of energy agency restructuring is fueled by market competition, the political debate has historically been charged by competition between the Energy Commission and the PUC.

In 1974, when the Energy Commission was newly born, the Little Hoover Commission recognized the potential for conflict and urged the coordination of policy making and policy implementation. In 1984, the Little Hoover Commission recommended ways to solve what by then had become a significant problem for the State.<sup>58</sup>

While critics and reformers over the years have placed the blame for

these problems at the doors of different agencies, an assessment prepared in 1994 by the Assembly Natural Resources Committee staff captures the protracted and serious nature of the problem:

*One of the fundamental issues driving the debate over energy agency reorganization for the past 15 years has been the overlapping responsibilities and conflicting approaches of the CEC and the CPUC. Many observers believe that CPUC/CEC competition and conflict, as well as CPUC's alleged overweening deference to protection of the status quo, have given California a confused and, at times, self-defeating energy policy. Many observers believe that any reorganization proposal should alleviate this problem, first and foremost.<sup>59</sup>*

## ***Shortcomings and Consequences***

Several analyses have identified the weaknesses in the current policy-making process. Some of the problems are not unique to energy policy, and can be expected to persist even in a restructured energy market. Among the shortcomings and their consequences:

- ***The Official Policy is Not Binding on Other Agencies.*** While the Biennial Report is official -- and may be of the highest technical caliber -- the policy document bears little legal or political weight. The document is not binding on other state agencies and the Energy Commission has no authority to take actions against agencies that do not comply with the document. Even the tone of the document is more advisory than compulsory.
- ***No Mechanism for Legislative Approval.*** While the policy is forwarded to the Legislature, the Legislature does not approve the document, and there is no direct connection between the report and specific statutory amendments or budget priorities that should be considered by the Legislature.
- ***Energy Commission Policies Require PUC implementation.*** In the case of both the Biennial Report, the electricity forecast and other policy documents prepared by the Energy Commission, implementation often has rested with the PUC. This arrangement invites frustration. And given the turf battles between these two agencies, that arrangement has been a source of great conflict -- creating uncertainty for market players and inflaming cynicism among the public.

Some inefficiencies are inherent in democratic policy making, particularly because of the intentional division of power between legislative, executive and judicial branches. But the inefficiencies are compounded, and the consequences increase, when fourth-branch agencies -- substantially independent commissions with policy making and adjudicatory authority -- are allowed to battle out policy differences.

Ironically, the problems between the Energy Commission and the PUC began to escalate when federal policies encouraged the beginnings of competition in the generation sector and left to the states the task of creating market-like mechanisms for integrating independent producers into the monopoly paradigm. The result in California was what a former public manager with experience in both agencies referred to in testimony to the Little Hoover Commission as an ever-escalating cold war:

*The California Public Utilities Commission and the Energy Commission have acted as superpowers in that conflict, each with its satellite constituency groups, but while the superpowers of the nuclear Cold War resided on opposite sides of the Iron Curtain, the superpowers in California's Cold War over energy policy both reside in the executive branch.<sup>60</sup>*

The Berlin Wall in this dispute was a 15-year battle over the Biennial Resource Planning Update -- a process that was intended to last two years and determine how much additional electricity generation the State would need and the best way to acquire it. In the course of the dispute, the PUC refused to accept the Energy Commission's analysis of future energy needs and a bidding process intended to yield low-priced providers turned into a regulatory free-for-all.

The experience provided ample evidence of the need to coordinate efforts, consolidate oversight authority when possible and provide quicker ways to resolve inevitable disputes between agencies with different missions. The Legislature is the traditional venue for establishing major policies and resolving disputes over major policies. But almost routinely, interest groups that are unsatisfied by the outcomes from the regulatory process have appealed to the Legislature. The Legislature, as a result, finds itself in a position of trying to sift through detailed regulatory decisions to resolve major policy issues, or tinkering with the details to satisfy the interest groups.

PUC commissioners, meanwhile have taken the position that unless the Legislature takes action, they are free to do as they please. In characterizing the "plenary power" granted to the Legislature by the Constitution over the Commission, the PUC's former president testified that the Commission does not have the authority to "hold to a course which the Legislature deems antithetical to the public interest":

### ***The War to End all Resource Planning***

Testimony from Southern California Edison revealed the expense and frustration that both the public and private sector endured when the PUC and the Energy Commission were at odds over the best policy course:

*The war between the CEC and the CPUC in the Biennial Resource Plan Update proceeding was a classic illustration of regulatory excess engendered by a terribly flawed process and a command and control mentality. There, the PUC rejected and relitigated the CEC's electricity report forecasts. Overly complex procedures and duplicated planning efforts severely exacerbated the regulatory war. The lengthy and expensive battle between the two agencies wasted resources for over a decade. It ended when FERC declared the result of the entire process invalid.*

*Yet it is equally clear that unless the Legislature elects to act, we have created in California the fullest expression of a tool for quickly and decisively defending the public interest, and we have vested that tool with a combination of legislative and judicial function and powers.<sup>67</sup>*

The legislative debate and reworking of the PUC's electrical restructuring plan is evidence of the policy-making dysfunction. The enormous policy decision to pursue competitive electricity markets -- and the general parameters of that transition -- is a decision that should be made by officials directly responsible to the people. At the same time, it may not be reasonable to expect legislators to fashion the specifics of a plan that must accommodate complicated engineering and economic analysis.

In this instance, however, the PUC proceeded to make both large and small decisions without formal involvement of the Legislature or even a public plan for involving the Legislature. Lawmakers responded by passing Assembly Concurrent Resolution 143, which required the PUC to assess certain issues, solicit public opinions, and report to the Legislature on those issues before further developing the plan to

unravel monopoly electrical service. Even then, lawmakers complained that PUC officials responded to the Legislature requirements as if the lawmakers were unnecessarily meddling into the Commission's regulatory arena. The Chairman of the Assembly Joint Oversight Committee on Lowering the Cost of Electric Service, told PUC officials in a public hearing that a better policy making framework was needed:

*We are on a merry-go-round here. The Commission issues a Bluebook in the spring of 1994 laying out certain dramatic proposals for restructuring the electric services industry in California and moving away from traditional ratemaking procedures as well as traditional ways in which electric services have been delivered to consumers with an indications they are going to move very quickly in doing this.*

*The Legislature, to try to become involved in what we consider an appropriate way, rushes to adopt a resolution which sets up this committee and sets certain dates so that we can get into the game. Now the Commission rushes to set up these evidentiary hearings which they think are a bad thing to do and wasteful of*

### ***Focus and Coordination***

The PUC's former director of strategic planning recommended two "guiding principles" for reform of the two commissions:

*First, California should bring focus, coordination and accountability to the way in which the State develops energy policy.*

*Second, California should improve the efficiency with which California implements its energy policy by re-inventing the structure and functions of government so that each of the State's energy-related agencies and departments is responsible for that portion of energy policy that a) best reflects its core business, and b) best matches its core expertise, or competency.*

*time and energy in response to ACR 143. I'm looking for a way to get off the merry-go-round and do it in a way that's more rational and cost-effective for the Legislature and for the Commission.*<sup>62</sup>

Two years later, policy makers, consumers and industry representatives again found themselves negotiating the same details of the restructuring plan simultaneously in regulatory and legislative arenas -- months after the State's utilities had petitioned federal officials to allow competition.

Just as the problems between the PUC and the Legislature will not go away with restructuring, these problems between the PUC and the Energy Commission will persist after competition. In responses to the Little Hoover Commission, both agencies described themselves as the major venue for setting energy policies -- with the PUC focusing on the effects that policies have on energy prices, and the Energy Commission on its statutory obligation to set the State's energy course.

Even if one of these agencies were to be abolished, the problem would persist because of the need to coordinate energy policies between air and water pollution agencies and with other states and the federal government. Those realities point reformers toward a combination of structural and procedural remedies.

## ***Clarifying Policy Roles***

**P**olicy analysts frequently debate how much policy-making responsibility should rest in the Legislature and how much should be delegated to departments and commissions. To the extent that major policy decisions are left to appointed commissions, the system is vulnerable to criticism that policy is being set by officials who are not directly accountable to the public. History also shows that interest groups who are unhappy with a regulatory outcome will seek redress in the Legislature, luring lawmakers into "micro-managing" the commissions.

For generations, political scientists and government reformers have considered policy making models that can efficiently yield "good" decisions. Most of those models can accommodate some, but not all of the human weaknesses responsible for many policy failures: overwhelming special interests, competing political views, insufficient information and human error. As a result, California should rely on the Legislature to do what it does best and let the Commission do what it can do best.

The Joint Committee on Energy Regulation and the Environment in 1991 developed recommendations that attempted to solve the problem. Some of the solutions were structural -- such as merging the energy functions of the PUC and the Energy Commission into a single agency. But the committee's research also recognized that consolidation -- while perhaps

essential in the long term -- would only go so far, given the dynamics of energy policy. Policy making is an ongoing process that requires the technical skills of expert agencies and the political direction of elected leaders. Among the Committee's recommendations:

*The Legislature and the Governor should provide energy agencies and energy-related environmental agencies with clear and uniform policy direction and goals in their enabling statutes. And the Legislature and the Governor should provide mechanisms for the ongoing development and articulation of State energy policies, concrete goals, plans and implementation programs of the Governor and his administration energy agencies.<sup>63</sup>*

That recommendation is consistent with a recommendation long advocated by the Chairman of the Energy Commission. The Chairman believes that the current policy making process articulated in the Warren Alquist Act should be amended to include legislative approval of the policy. As a result the Legislature would then be expected to convince or compel other state agencies to comply with the policy.

One solution would be for the Legislature to annually establish policy goals for the commissions and for the commissions to then use their technical expertise to pursue those goals. That process would allow the Legislature to do what it does best -- express the desires of the voting public. It also would allow the commissions to do what they do best -- gather the detailed information and provide the careful deliberations that are essential to making new policies work in the realities of the marketplace.

This process is similar to performance-based budgeting. That process is geared toward making line agencies more productive and accountable by focusing them on outcomes rather than inputs. Rather than assessing budget proposals based on personnel years, for example, they are assessed on how many children will be educated. A byproduct of performance-based budgeting can be a better relationship between the Legislature and the agencies. Legislators can make the policy-oriented choices they want without having to manipulate budgets. The agencies, in turn, get clear direction on what is expected of them in the next year and can be held accountable to those goals at the end of that year.

### ***Four Hurdles for Decision Makers***

Researchers describe four inherent problems that policy-making venues must account for in order to improve decisions:

- 1. Opportunism.** Controlling power to be certain it is used only in the public interest, given the limited number of saints available for government service.
- 2. Differing political values.** Defining the public interest on issues for which any decision helps some people and hurts others and for which there are different political views among those who are not personally affected by the issue.
- 3. Insufficient information.** Providing adequate information to make rational decisions when critically important information is either missing altogether or controlled by individuals or firms that have an incentive to misrepresent it.
- 4. Bounded rationality.** Guarding against errors caused by the policy maker's lack of expertise or inability to fully utilize the available information to devise policies that accomplish given policy goals.

To fully adopt performance-based budgeting is an involved process that would be too much to expect of the agencies guiding dramatic restructuring in utility markets. But adapting elements of performance-based budgeting that could clarify policy-making duties would be easier than debating broad and detailed policy issues before both the oversight commissions and the Legislature.

## ***Recommendations***

***Recommendation 4-A: The Governor and Legislature should enact legislation requiring the Energy Commission to annually appear before the Legislature to review the agency's performance toward meeting established policy goals and to set specific goals for the Commission to pursue over the next year.***

This process would allow the Legislature to better monitor and more timely influence the direction of the oversight commission, provide an opportunity for better relationships to develop and discourage venue shopping.

***Recommendation 4-B: The Governor and the Legislature should enact legislation requiring the director of the Department of Conservation to biennially prepare an assessment of the department's existing energy-related programs and propose changes to eliminate obsolete programs, improve existing programs or create new programs.***

The document should be submitted to the Governor for approval and forwarded to the Legislature for consideration as statutory amendments or budget reallocations. The document should specify what actions would need to be taken by other departments to accomplish the policy changes. It should also specify what actions other departments would have to take, if any, to make the policy recommendations work.

***Recommendation 4-C: The Governor and the Legislature should enact legislation requiring the Secretary of the Resources Agency to participate as a non-voting advisor in Public Utilities Commission proceedings concerning energy-related issues.***

A significant failing of the current policy making framework is the gap between the Energy Commission, the Public Utilities Commission and the State's executive. Providing for a member of the Governor's cabinet who also oversees the Energy Commission to take part in the PUC's energy-related proceedings would bridge that gap. This arrangement would only be needed as long as the PUC retains jurisdiction over energy utilities.

# Telecommunications

- ❖ *The task of easing competition into the telecommunications market is extremely difficult, requiring the PUC to predict both technological and economic futures and to constantly assess the results of its decisions to remedy unwanted consequences.*
- ❖ *The PUC's "road map" for how it will define the telecommunications marketplace has provided needed certainty to market players, but competitors and consumer interests need a detailed plan for how state regulation will be reduced as competition takes hold.*
- ❖ *The emergence of new technologies and the maturation of competition will require an evolution of policy choices that should be collaboratively derived between the PUC and the Legislature.*



# Keeping the Market's Pace

**Finding 5: The fast-paced dynamics of the telecommunications industry, with its importance to the California economy and the complexity of new public policy issues, is not being adequately overseen by a commission that regulates numerous other essential business sectors.**

**T**he telecommunications revolution is changing the way Californians live, work and play. New services, new technologies and competition for the traditional basic services are progressing at a stunning pace.

These trends create complex policy choices about evolving and dueling public interests. Once made, implementing policy choices can be just as challenging -- given the need to infuse competition into monopolies in ways that are economically sound, legally correct and that satisfy a demanding public.

Because these changes are fast-paced, timeliness is a critical concern. Because the PUC's decisions will influence the economic health of the market, the quality of its decision-making is paramount.

And because of the uncertainties of a nascent market, the stability that can be provided by a sound deregulation strategy is important to potential investors. A fundamental prerequisite to achieving this criteria is the time and focus that the Public Utilities Commission can apply to these issues.

## *Restructuring as Norm*

For more than a decade, the PUC has been in the process of infusing competition into some aspect of the traditional telephone monopoly. Simultaneously, it has seen the birth of new telecommunications services that were never monopolies, and the PUC instituted economic regulation as a means of encouraging competition. The PUC, in its Vision 2000 process described these evolutionary trends:

*The traditional monopoly of telephone companies has now been breached by competing firms in virtually all aspects of that industry. Through a combination of rapid decline in the cost of providing basic telecommunications services and the emergence of markets for high-value new services, virtually all of the natural monopoly aspects of telephony are evaporating.*<sup>64</sup>

These trends are challenging the PUC's traditional regulatory framework in three ways:

**1. Expanding Markets.** Traditional and technological distinctions between services are rapidly eroding. As a result of digital and fiber optic technologies, the commonalities between telephone, cable and home PC/Internet services are increasingly strong. The PUC has traditionally not had jurisdiction over all of these market players and its role in regulating new industries spawned under the color of competition is unclear. The number of market players is rapidly increasing, as well. In the last 15 years the telecommunications companies within the PUC's jurisdiction have increased from 75 to more than 400, competition has not even begun for local telephone service and cable companies are still gearing up for entry into the telecommunications market.

**2. Mixed Markets.** The PUC has struggled to fairly regulate traditional monopoly providers, while gradually opening markets to competition and providing some oversight of new entrants. Pacific Bell, like regional bell companies across the country, has complained that state regulators have not even-handedly accomplished this task. The result is essentially a dual regulatory scheme that is vulnerable to criticism that competitors are treated unevenly.

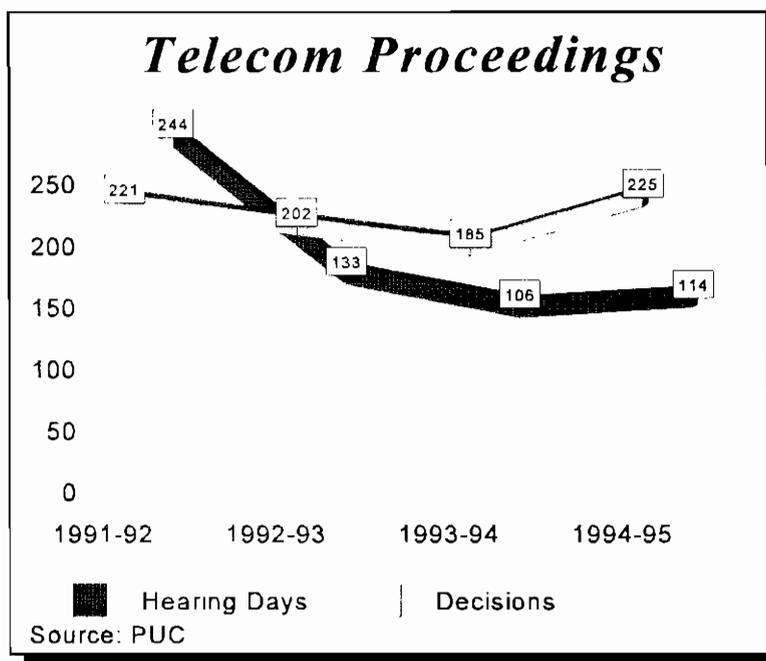
**3. Regulatory Manipulation.** The PUC's rules and the timing of market changes can significantly influence which companies will succeed and which will fail. As a result, the PUC's proceedings have become the venue for fierce competition among market players, each seeking to use the process to advance its strategy or hinder the competition. In a recent cost study analysis, the new competitors alleged that Pacific Bell was gaming the analysis in order to give itself advantage. After laborious review, the PUC decided that for the most part Pacific Bell had assigned costs correctly -- but that the incumbent did make errors in its favor equal to several hundred million dollars in potential revenue.

Congress formally acknowledged the evolution of technologies and the need for regulatory change with the passage of the Telecommunications Act of 1996. The act, asserting that more competition was the solution to existing market power, allows for cable television, long distance, cellular and local telephone companies to enter all other aspects of the market. AT&T, in its testimony to the Little Hoover Commission, said the law requires the PUC to take a leadership role to encourage a well-functioning market:

*Rather than waiting for technological change to eliminate observed market power, the Commission, in concert with the Federal Communications Commission and the U.S. Department of Justice, must design and implement new regulatory structures intended to introduce competition to the last market still oppressed by market power, the local exchange market... These are critical responsibilities. Get it wrong and the existing benefits of competition in the long distance market will be lost if the local companies enter the long distance market before competition controls their market power. The commission must be active in its new roles and it must rely on its institutional expertise. The Commission cannot accept a reduced role, not sit on the sidelines.<sup>65</sup>*

The Federal Communications Commission (FCC) in the summer of 1996 released a 700-page ruling to guide the state utility commissions through this transition to competition.

But even before the federal act was passed, the PUC was responding to these trends with complicated proceedings intended to create an economic and regulatory foundation for competition whenever technology allowed more than one provider and consumer choice. At the same time, it established regulations intended to control the potential market power abuses of incumbent players and prevent portions of the network from returning to monopoly status. Beyond the restructuring of monopolies, the overall market trends have impacted virtually all of the PUC's telecommunications work -- complicating even routine issues, such as creating new area codes. In its recent designations of new area codes in the Bay Area, Southern California and Sacramento Valley -- largely in response to demand created for new numbers by fax machines,



*After a decline in activity, the PUC has seen an increase in telecommunications cases in recent years.*

cellular telephones and modems -- the PUC traded convenience to existing phone companies for a level playing field for future competitors.<sup>66</sup>

In the new regulatory world, old issues have to be revisited. The State has a long-standing policy to subsidize rural areas and the most basic telephone services so all residents can have access to telephones. But maintaining that policy in competitive markets -- and expanding access to high technology uses, as required by the 1996 federal law -- will require periodically recrafting the mechanisms for achieving those policies and rebalancing competing public interests. Similarly, the State has a long-held policy to protect the privacy of telephone users, but the development of Caller ID and other services requires reconsidering those policies.

PUC managers in a variety of roles -- advisory and compliance, ratepayer advocacy, safety and enforcement and administrative law judges -- all said that their workload has increased significantly during this protracted

transition, as they attempted to design and implement new rules, deal with more participants, and respond to new consumer complaints. As technically complicated or politically difficult as some of these decisions can be, the long-term economic importance of timely, correct and consistent decisions are obvious to all of the participants -- and concern that the PUC cannot satisfy those needs without some changes is growing among many of them. GTE, a local phone monopoly aggressively pursuing those other services, characterized the concern:

*The timely availability of state-of-the-art telecommunications services is a key element in the attractiveness of the State as a place to retain existing jobs as well as locate new jobs. Absent dramatic change, current regulatory process, defined when markets were not competitive, can slow delivery of new services and negatively impact the competitiveness of business in the State, especially as the utility markets become competitive.*<sup>67</sup>

## ***Demonopolizing Telecommunications***

The PUC has conducted a number of proceedings designed to open the technical network and the market to competition.

***New Regulatory Framework.*** With this proceeding, the PUC replaced rate-of-return rate-making for the large local exchange carriers with incentive-based or pay-for-performance rate-making. It also attempted to differentiate between a company's monopolistic services and those it provides in a competitive market.

***Open Access Network Architecture Development.*** With this proceeding, the PUC is intending to resolve the technical issues that will otherwise prevent new market entrants from offering services as easily or of the same quality as the incumbent providers. The goal is to offer seamless connections that would encourage consumers to shop and require competitors to invest in new services or lower prices as a way to capture market share.

***Implementation Rate Design.*** With this proceeding, the PUC created the rules that allowed for competition for regional toll calls. The proceeding required a combination of technical and pricing issues to be resolved and provided for the first major incursion into the domain of the local exchange carriers.

***Total Service Long Run Incremental Cost Studies.*** With this proceeding, the PUC has attempted to determine the capital and operational costs for every aspect of the network, so that new entrants can pay for that portion of the system they use.

## *The Need for Dramatic Change*

The regulatory issues before the PUC are complex and there is often more than one right answer. However, testimony to the Little Hoover Commission and analysis conducted in academic and other research forums indicate that the PUC needs to improve the timeliness with which it makes decisions and more fully assess the consequences of decisions once it makes them.

**Timeliness.** The single greatest complaint made against the PUC by telecommunications interests is that it takes too long to gather information, deliberate on the options and make a decision.

This is not surprising, given the complexities involved and put in the context of the PUC's traditional workload. Telecommunications comprises only about one quarter of the proceedings before the PUC. And as complicated as the telecommunications issues can be, the PUC has dedicated much of the last three years to pioneering electricity restructuring and remaking its own internal organization. Testimony from Pacific Bell described the consequence this workload has on other industries regulated by the PUC:

*Commissioners must divide their focus among a daunting range of oversight responsibilities and workload for five disparate industries. Some of the industries are further along the progression toward open markets and ultimately deregulation than others. The divided attention may inadvertently slow progress.<sup>68</sup>*

The Public Utilities Commission takes so long to decide these cases that one telephone provider proposed that the PUC be held to a two-year statutory deadline for making decisions. Two years, in the eyes of this long-time PUC regulatee, would be considered major progress.

One cellular telephone provider complained it took the Public Utilities Commission 16 months to review the construction standards that were designed to effectively get the PUC out of the business of reviewing and approving every cellular tower site. The Open Network Architecture Proceeding was opened in 1993 and is not expected to be completed for the large companies until 1997.

Roseville Telephone, a small company that serves a Sacramento suburb and is fearful of losing customers to AT&T, GTE, Pacific Bell and other giants, said it took the Public Utilities Commission more than a year to review its request to establish a holding company that the company needed to prepare for competition.

Pacific Bell testified that the Public Utilities Commission takes months to make decisions that market players need answers to quickly: "New product introductions and changes to our tariffs take months of

regulatory approval with processes that also allow competitors to needlessly delay approvals.”

The Legislature, in the PUC reform bill enacted in 1996, responded to these complaints by declaring its intent that the PUC decide cases within 18 months of being opened. It placed a statutory deadline of 12 months for the resolution of adjudicatory cases. The law also requires the PUC to make a final decision within 60 days of a proposed decision being released -- allowing for the Commission to extend that deadline in “extraordinary circumstances.”

During the legislative debate, PUC officials argued that a deadline of any sort would tie their hands in making the best decision possible. And in other cases where the Legislature has imposed decision-making deadlines, such as the Permit Streamlining Act, the restrictions have not proven to result in high-quality and timely decisions. Still, the deadline provides a constant reminder of the importance of making timely decisions.

**Quality of decision making.** There is also evidence that in the PUC’s sincere efforts to make timely decisions, it often either makes fundamental errors or lacks the focus or resources to assess its decisions and modify its regulatory strategy when it is not having desirable effects.

One of the best examples of this problem is the controversy that erupted over the Implementation Rate Design proceeding. In that case, the Public Utilities Commission was setting rules for competition for toll calls within local calling areas. After months of hearings and the development of an exhaustive factual record, overburdened Commissioners turned to one of the market players to draft an alternative order. This breach of procedures and public faith created an enormous outcry among consumer and industry groups, fueled criticism that the Public Utilities Commission is too close to the incumbent utilities and delayed for more than a year a critical decision in the path to competition.<sup>69</sup>

The procedural failings in other decisions are not as blatant. And to be fair to the Public Utilities Commission, decisions of such contentious issues will always have their critics. Still, there is a pattern of evidence that indicates that more attention could yield decisions that more accurately reflected or surgically accomplished what the Public Utilities Commission has set out to do.

### ***“Extraordinarily Slow” Decision-making***

Roseville Telephone described the PUC’s decision making as “extraordinarily slow and awkward.” It cited as an example the 14 months the PUC took to review Roseville’s application to create a holding company, which the utility wanted to better compete against the largest phone companies in the nation.

*The issues raised by Roseville’s holding company application have already been considered in other Commission proceedings and were in no way unique. The fact that it requires more than a year to obtain Commission approval for a change in corporate structure ... illustrates how the current regulatory environment is ill-suited to the needs of participants in a competitive market place.*

For example, the PUC's New Regulatory Framework calls for keeping separate expenses associated with monopolistic services and those for competitive services. But critics are concerned that the PUC has been too willing to let ratepayers pay for investments that will enable the incumbents to get an even larger head start on potential competitors -- expenses that should be paid for by shareholders, who will benefit from the profits earned in a contested market.

In addition to the effect on rates, the critics argue, the PUC is undermining its own goals by allowing the monopolies to enhance their incumbent position to preserve their market share. The Center for Public Interest Law testified:

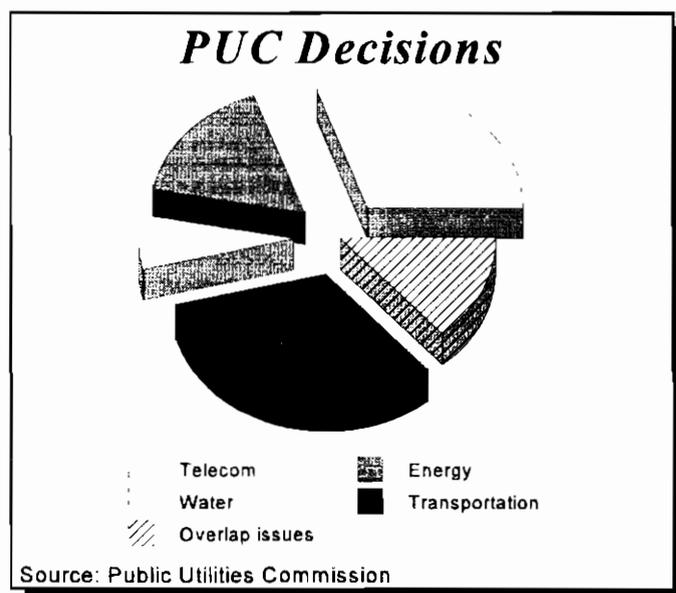
*The PUC has exacerbated these problems by moving from traditional "fair rate of return" maximum rate regulation to an allegedly "incentive" based system. Translated, it allows the monopoly power sector to earn above fair market rates of return based on formulae which may, or may not, have anything to do with enhanced efficiency. The failure to police excessive profits from the monopoly side only exacerbates inevitable abuses flowing from the cross subsidies, subtle tie-ins, and other traditional anti-trust violative practices.<sup>70</sup>*

Some market players believe the PUC has done a good job of making consistent decisions in an uncertain market -- making California a good place for expanding companies and investors to put their talents and treasures. At the same time, they are concerned about the PUC's ability to sustain that record as competition in all utilities accelerates.

## ***Finding the Time and Focus***

Over the last two decades, the Public Utilities Commission has been faced with increasingly complex policy issues that have made it virtually impossible for the five appointed commissioners to be integrally involved in all of the important decisions before the Commission. The energy, economic and environmental crises of the 1970s and early 1980s greatly complicated the task of regulating utilities. The gradual push toward deregulation of the transportation industry and competition among the utility providers has further burdened the PUC.

The accumulated consequence of these trends has been an enormous workload that has required an increasing delegation



*The PUC's caseload in fiscal year 1994-95 reflects its historic multi-industry responsibilities.*

of duties and increasing reliance on staff to make policy-level decisions. In cases where the staff has worked effectively, the Public Utilities Commission has been vulnerable to criticism that unaccountable civil servants have been making decisions that should be made by politically appointed commissioners. In cases where the decision-making process has not worked smoothly, the Commissioners have been criticized for not following the record, or not providing equal access to all parties or not acting swiftly enough.

In reviewing PUC procedures for the Legislature, an advisory group in 1994 recommended ways the Commission could better manage its caseload.<sup>71</sup> But one former PUC Commissioner on the Advisory Group concluded "the problem confronting the Commission is jurisdictional overload ... too much to do, too little time to do it." The former Commissioner said the dilemma will worsen as long as the PUC tries to arbitrate competition -- a function it was not designed to perform:

*Regulating during a time of transitional competition is tough under any circumstances, but may become almost impossible to do "right" without rethinking the extent of the PUC's agenda.... In my opinion, reform without jurisdictional modification will not be enough in the long run.<sup>72</sup>*

During the PUC's Vision 2000 process, Commissioners and their staff struggled with how to perform all of the functions the PUC wants to perform and at the same time comply with pleas from participants for greater commissioner involvement in proceedings. One Commissioner, during public deliberations of the dilemma, described the pressures:

*I am frightened beyond belief that someone thinks that I'm going to sit through every evidentiary hearing, sit through every workshop, sit through every prehearing conference, that me or my adviser is going to sit down and draft a report or proposed decision or what. I simply don't understand the process, but I have tried to participate in prehearing conferences and every commissioner here can double in spades my experience that it's impossible when three are scheduled at the same time in different hearing rooms. You just can't do it. ... I measured today my written materials that I owe the parties an obligation to read. The folder for the last three days was somewhere between six inches and a foot thick. I'm not telling anybody news when I tell them that I don't read every word. No one reads every word.<sup>73</sup>*

The Legislature addressed this problem in 1996 by enacting SB 960. Lawmakers said their intent was "to ensure that members of the Public Utilities Commission shall be integrally and directly involved in and accountable for the Commission's decisions," and as a result improve "the quality and timeliness of Commission decisions."

In the case of legislative-like decisions -- the ones in which competition-related issues are addressed -- the law requires that assigned

Commissioners be present in every formal hearing and prepare the proposed decision. But the present workload will make that requirement difficult if not impossible to meet.

The incumbent telecommunication providers and some of their potential competitors testified that a paramount concern was keeping the PUC focused on regulatory decisions needed to allow for vigorous and fair competition -- and not distracted by major organizational changes. They were also concerned that unless some significant changes were made, the PUC could not make hard decisions in a timely manner, let alone assess decisions after implementation has begun and make any needed modifications.

Pacific Bell, for instance testified that there may be some saving in having one commission oversee multiple industries: primarily the efficiency and flexibility that comes with a consolidation of resources. The telephone utility also cited disadvantages to keeping multi-industry oversight intact -- including the possibility that the PUC's workload may slow the restructuring process in energy and telecommunications.

That does not leave the State or the PUC many options. No other state agency has the expertise to effect the regulatory changes required, and the only way to allow the Public Utilities Commission to concentrate on telecommunications is to focus its attention on those issues.

### ***The Energy and Telecommunications Link***

An important issue in the debate over jurisdiction of California's future utilities is the relationship between energy and telecommunications. One alternative recommended to the Little Hoover Commission was to merge the PUC and Energy Commission's energy and telecommunications functions and transfer the PUC's water and transportation functions elsewhere.

That plan would keep in place the expertise needed to oversee issues in common between the two industries -- principally their history of monopolies, the emergence of competition, and the potential for some companies to get into the energy and telecommunications markets.

But this alternative has some important disadvantages: The agency would have an enormous workload -- trying to restructure both industries simultaneously and develop new skills to oversee competitive markets. Many competitive energy market players did not want to be within the PUC's jurisdiction. And while some companies may seek to capitalize on existing right of ways to offer multiple services, the regulatory issues concerning telecommunications and energy are likely to grow further apart as the two industries leave behind their greatest commonality -- a history as monopolies.

## ***Recommendations***

***Recommendation 5: The Governor and the Legislature should enact Legislation directing the PUC -- after the development of competitive energy markets -- to focus its attention solely on the development of competitive telecommunications markets by monitoring for possible market power abuses, overseeing telecommunications public policy programs such as universal service and identifying unfair business practices.***

A number of policy reviews in recent years have found that the PUC has too many responsibilities to adequately fulfill them all. Changes in technologies and emerging competitive utility markets have increased the workload. Successful oversight of the telecommunications revolution will rest in large part on the time and focus the PUC can bring to the job.

# Redefining Public Interest

**Finding 6: As new telecommunications technologies and services emerge, the State does not have a systematic way for determining areas of public interest or the extent of government oversight that is necessary.**

Put most simply, the PUC's role has been to use regulation to perform price setting and other market functions in the absence of a competitive market. The fundamental issue is: In a competitive market, what regulations if any should the PUC impose? Complicating this simple version of reality is that telecommunications has not changed from a monopolistic service one day into a fully competitive market the next.

Competition has come slowly, to different aspects of the network at different times. Upstart providers have had to gain momentum in order to compete against the incumbents, who are strong from decades of monopoly operation. Incumbent utilities are simultaneously competitive enterprises and monopolies -- creating an enormous task for the regulator of sorting one out from the other.

In new technologies, such as cellular, the PUC's regulatory objectives have been even more confused. The PUC maintained for years that it had rate-setting authority and so established tariff rules, while at the same time asserting that it was relying on the market to set prices.

While the PUC has conducted numerous proceedings in an attempt to fairly usher competition into the market, even its supporters do not believe the Commission has done enough to predetermine when it will stop regulating.

## *When to Act*

The PUC has set out to bring competition into the telecommunications industry, and has expressed an intent to replace government regulation with consumer choice. The PUC is complimented, especially by new entrants, for sticking to its plans to dismantle the monopoly structure that prevents alternative providers from entering the market. The concern arises over the PUC's long-term role and its ability to develop and stick to plans to eliminate regulation when the consumers have choice.

The Public Utilities Commission has taken a two-track approach to the trends: The first are those proceedings, previously described, to usher competition into the telephone network or regulate new services. The second involves the PUC's Vision 2000 process, in which it has attempted to define its role in competitive markets and adapt its internal structure to match its new role. The plan makes two changes directly related to the regulation of telecommunications:

- ***Creates a Telecommunications Division.*** As with the other industry-based divisions created by the plan, Vision 2000 consolidates the telecommunications experts into a single office responsible for monitoring the industry, assisting in the development of rules and implementing regulations.
- ***Creates a Customer Services Division.*** The PUC's efforts to thwart over-aggressive marketing by long-distance companies helped to convince Commissioners that the PUC will play a major role in policing the markets for unfair business practices and representing customers in disputes against companies.

As part of the Vision 2000 process the Public Utilities Commission prepared "business plans" for each of the industries it regulates. The plans describe long-term market trends and the PUC's attempts to align regulation to the changing industries. The strategies list a number of priorities for PUC action -- including the streamlining of regulations to accelerate the pace of innovation in telecommunications.

The Vision 2000 plan describes what the PUC sees as its role in competitive markets: facilitating the transition by changing regulations to promote competition, acting as a referee between industry participants; and developing rules to create a "level playing field" among competing carriers. Looking ahead to the year 2000, the Public Utilities Commission described its role in telecommunications as "protecting consumers and those with special needs, safety and environmental issues, establishing rules for and monitoring competition."

Missing from the document is a description of when the PUC will cease to regulate participants because competition has developed.

## *When Not to Act*

In the eyes of incumbents, upstarts and consumer groups, it is not clear when the PUC will regulate and when it will not. Without an articulated strategy for forbearance consumer groups and potential competitors are constantly concerned that the Public Utilities Commission will pull back too quickly, allowing incumbents to use their market power to take advantage of customers and fend off competitors. Similarly, incumbents and entrepreneurs venturing into brand-new markets are concerned that the Public Utilities Commission will not let go of its role as an economic regulator.

These are not easy issues. The lesson from deregulation so far is that the presence of more than one provider does not necessarily mean that competition will keep sustained downward pressure on prices. In some cases, the former monopoly may exert market power to keep prices high. But more commonly, the dominant provider maintains higher prices. Rather than try to gain market share by lowering prices, the new entrants are satisfied with the super profits that come by charging just below the dominant provider.

Studies by Harvard and Yale economists both show that the price cap regulation of AT&T has not provided sufficient incentives to hold down costs and lower prices, and the competition from competitors is not enough to force AT&T to lower prices.<sup>74</sup> Similarly, studies done by RAND and others have shown the ineffectiveness of those controls.

But economists and other policy experts differ on the appropriate government response in these situations. One economist summarized the dilemma:

*One of the greatest challenges confronting regulation today is to know when not to regulate. As competitive forces strengthen, prices should be determined in the marketplace. But at just what point competitive forces are strong enough to permit the end of pervasive regulation is yet to be determined.*<sup>75</sup>

Regulators faced a similar problem after the airline industry was deregulated. Dominant carriers charged prices far above costs until a number of low-priced carriers "broke" from the incumbents and offered low fares on heavily traveled routes. Experience in that aspect of airline deregulation, at least, has shown that government forbearance from regulation eventually allowed for the desirable result -- intense competition that has driven down prices and allowed millions more people to travel by air.

While competition is still emerging at the local level, there is evidence that the PUC still may be regulating too much. An analysis published by the Brookings Institution showed that regulators -- including the California PUC -- have been reluctant to separate out those aspects of

the market that are competitive to let competition set price. Instead, the regulators impose restrictions with the intent of controlling market power at the expense of delaying or deferring the development of competition.

The analysis concluded that incumbent monopolies usually benefit the most from "half-hearted" reforms: "The regulator should be left to specify interconnection rules, unbundling, an accounting separation between wholesale and retail functions for firms with bottleneck monopoly, and nondiscriminatory pricing for such integrated monopolists."<sup>76</sup>

The PUC faces nearly identical issues when determining its role in new markets where there is no history of regulation and where there is not a monopoly provider -- but there may be concerns about inflated profits. The PUC has asserted that all new telephone companies are utilities under Public Utilities Code Section 216. Some companies have challenged this in PUC proceedings, but so far not in court.

When the first cellular telephone licenses were issued in 1983, the FCC issued two licenses in every market. The "duopoly" arrangement was thought to provide enough competition to thwart the need for government price regulation.

Airtouch, however, was ready to offer services in its first market before its competitor. As a result, the PUC imposed regulations similar to those it had adopted for monopolies, and retained many of the rules even after the duopoly developed.

A number of other states also initiated some form of economic regulation. California's, however, was considered to be among the most rigorous in the nation. While the PUC maintained it would let the market determine the prices, it dampened market forces in a number of ways: It required companies to post tariffs and limited changes that could be made in the tariffs, which

### ***When Regulation Meant Higher Prices***

The cost of imposing too much regulation on new services that were never monopolies was, in at least one case, higher consumer prices. A 1995 analysis by MIT professor Jerry Hausman showed that regions where cellular telephones were regulated (including San Francisco and Los Angeles) had significantly higher prices and lower penetrations than regions with no or little regulation.

The study found that the regulation -- even passive rate regulation such as tariff posting requirements -- allowed competitors to know each other's prices before they went into effect. As a result, competitors could either match the price or come in only slightly under it. The postings also allowed competitors the opportunity to protest the prices to the PUC.

The study, which was highly critical of the PUC's cellular regulation, shows that the PUC needs better standards for determining when it will regulate these new and changing services and when it will forbear from regulation. Individual regulatory decisions then need to be reassessed to determine if they comply with the standards.

Testifying before Congress in October 1995, Hausman said:

*State regulators assume (as a matter of faith) that their regulation is better than a situation of imperfect competition. No economic theory nor wide-ranging empirical study supports this assumption. Cellular telephone proves it to be false in this particular industry.*

encouraged cooperation among competitors. It required a minimum mark-up on services to encourage resellers to enter the market. And it prevented cellular service companies from selling equipment.

The result of these regulations, according to an MIT researcher, was higher prices and fewer people being served by the companies.<sup>77</sup>

In 1993, Congress prohibited states from regulating cellular rates, unless they could show a compelling reason to do so. Eight states, including California, argued their case before the FCC. In 1995 the FCC concluded that California did not have a valid reason for its cellular regulations. And in 1996, to eliminate concerns by PUC Commissioners that the Public Utilities Code compelled them to regulate cellular phones, the Legislature passed a bill specifically exempting cellular phones from PUC rate control.

The dangers lurking behind the PUC's case-by-case strategy for determining when it should intervene depends upon one's perspective. New entrants and consumers are concerned that market power abuses -- and higher prices for consumers -- will be tolerated in the name of encouraging competition. The incumbent monopolies are concerned that the PUC will tie their hands -- letting competitors capture too much of their market before they are truly free to compete. These concerns will heighten as competition is ushered into the local phone business and as more market players -- many of them veterans of the regulatory arena -- use each proceeding to try to gain a competitive advantage.

This problem is as old as modern-day deregulation efforts. By the mid-1980s, the FCC and some state commissions were setting standards for when they would stop regulating. So the good news is that California does not have to stumble down a darkened path.

The recommended solutions depend on one's perspective, as well. Pacific Bell believes the PUC should quickly concede its regulatory role and the Legislature should eliminate a number of "obsolete" statutes, including the PUC's ability to set rates for Pacific Bell.<sup>78</sup> Other service providers describe a need to eliminate "regulatory underbrush" that complicates proceedings or biases the Commission's decision making in one direction or another.<sup>79</sup>

### *From Rates to Prices*

A 1995 analysis published by the Brookings Institution, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications*, found that many states struggled with trying to partially deregulate telephone markets. The researchers concluded that market players were better off in states with "well-defined ground rules" and consumers were better off in states when regulators are more willing to let the market work:

*Our analysis showed that halfhearted reforms such as partially flexible pricing do not necessarily move rates in the right direction. Nor does it benefit anyone other than the incumbent firm to partially deregulate without allowing full competition.*

For Roseville Telephone, the solution was easy: Proposals to lower rates

should be approved immediately. As it now stands, the company must submit promotional and advertising material to the PUC before it can receive permission to offer a promotional rate for new services to its customers.

In some cases there are fundamental gaps between where the PUC's decisions are headed and what the law requires of the PUC. Most notably, the code requires the Commission to set fair and nondiscriminatory rates. Not only will the Commission not set rates in the future, but market strategies begin with companies establishing discriminatory rates to capture specific groups of customers.<sup>80</sup>

In other cases, the PUC has chosen to simply ignore regulations or statutes that are no longer meaningful. Among those rules that Pacific Bell complains are obsolete is one for regulating advertising rates in telephone directory yellow pages -- but the PUC has not used that authority in years and it is hardly a roadblock to competition.

The Legislature's PUC Reform Conference Committee struggled with some of these concerns and made some progress toward realigning the Commission's statutory and regulatory framework with the needs of a competitive market. SB 960 requires:

- The PUC to provide the Legislature by March 1997 with "recommendations for changes to regulations or statutes that may be required as a consequence of the changing competitive environment in which regulated and unregulated entities are competitors."
- The PUC, in consultation with the Law Revision Commission, to submit to the Legislature by June 30, 1997, a report on revisions to the Public Utilities Code that are needed as a result of the restructuring of the electricity, gas, transportation and telecommunications industries.

## *Sounding Regulatory Retreat*

The Legislature's first requirement focuses on one of the most immediate concerns -- the regulations and statutes that might distort the position of competitors in a market that is partly monopolistic and partly competitive. Its second requirement provides a process for a more comprehensive review of the statutes that may minimize the gaming of various competitors, and the Legislature did not leave the task solely to the Commission.

But the heart of the issue is when and how the PUC will intervene in the market, whether it will make those decisions consistently, and whether it will have the self-discipline to let the market function. It will be necessary to allow unique circumstances to influence decision making. But some principles for guiding decision making could benefit the market

players, consumers, the PUC and the Legislature, which is often called on to provide relief to whichever participant is unhappy with a regulatory decision.

Standards or guidelines, especially ones crafted by the PUC and approved by the Legislature, could diminish concerns that the State will not back away quickly enough to let competition flourish and reassure those who believe the Commission will retreat before competitive pressures can hold down price in the absence of regulation.

GTE, an incumbent local exchange carrier that also is aggressively seeking to compete in areas where it was previously restricted, believes the Commission should establish a benchmark for regulatory retreat. Specifically, it believes the PUC should forbear from regulating any time that customers can truly chose among service providers. The benchmarks would "assist in assuring that regulation in California was relevant and at the same time assure the standards that customers should expect."<sup>81</sup>

### *The Federal Checklist*

The Telecommunications Act of 1996 set benchmarks that predetermine when regional bell telephone companies, previously prohibited from entering the long-distance and equipment markets, should be allowed to compete in those sectors. The benchmarks were intended to encourage competition by providing certainty to potential market players.

The checklist included a number of requirements intended to ensure that the regional bells were facing competition in the local exchanges before they tried to capture customers in other markets -- including the availability of interconnection, the unbundling of local services, number portability and resale provisions.

Similar to GTE's recommendation is Southern California Gas Company's call for a PUC rule-making order to define when competition is deemed to be adequate -- allowing for case-by-case determinations, but sending a clear signal when the regulator will stop regulating.

It may be that more than one benchmark is appropriate. While the PUC may want to forbear from most regulation when more than one provider exists, it may want to retain a certain degree of regulation until the quality of those consumer choices reaches a predetermined standard.

Since most of these benchmarks would require the commission to stop doing something that it is required by statute to do, GTE believes it would be appropriate for the standards to be approved by the Legislature.

Even more so than with energy, many market players and policy experts see a day when all aspects of the telecommunications industry are truly competitive, economic regulation can cease, and the State will be left with a few basic functions: public safety and network reliability; administering programs for the deaf and disabled or to subsidize connections to rural areas or low-income residents; registering entrants and monitoring the market to determine when and where competition is failing to control prices.

The PUC envisions itself doing these functions, along with the more activist roles of resolving disputes among market players, resolving disputes between providers and consumers, enforcing unfair business practices and antitrust actions.

In the process of establishing principles or benchmarks for when it will intervene and when it will forbear from intervening, the Commission would necessarily have to detail its ultimate role in a competitive market. The Legislature, in its role of determining what functions state agencies should perform, may not agree that all of those functions are appropriate for the State, or they may find that those functions may be more appropriately done by another state agency.

## ***Recommendations***

***Recommendation 6-A: The Governor and the Legislature should enact legislation declaring clear standards for when telecommunications services are fully competitive, when they are vulnerable to possible market power abuse or when they are so affected by the public interest that government intervention is warranted.***

The PUC should be required to use those standards to establish the scope of its activities and routinely review the consequences of those activities. The standards should include a time line and the PUC should report to the Legislature on the progress or variations from the time line. The goal is to maintain consistent progress in an accountable way toward regulation in line with markets.

***Recommendation 6-B: Beginning in the year 2000 and every five years after that, the Public Utilities Commission should undergo a sunset review to determine if the PUC is still needed.***

The sunset review will provide at least two benefits. The first would be to make sure that any basic function, such as monitoring for potential market power abuses or registering new entrants, has not outlived its usefulness and those functions or the PUC itself is no longer providing significant value to Californians. The second benefit would be to provide the Legislature with the opportunity to reassess the State's role in telecommunications and the best way to fulfil those roles.

# Setting Policy

**Finding 7: The State's practice of setting telecommunications policies on a case-by-case basis encourages market players to seek the same changes from the Legislature and the Public Utilities Commission. This venue shopping spurs occasional conflicts and confusion among government entities that could prove costly to nascent competitive markets.**

Just as in energy, it has not always been clear when the Legislature will be the venue for establishing a policy, and when the Public Utilities Commission is the appropriate venue. This tension is predictable, given the broad policy making or legislative-like functions that the Commission performs.

The tension also provides some public benefit -- and under the current structure is one of the few ways to bring political or legal pressures to bear on the PUC.

And the tension will never fully be resolved, because a tenet of American democracy is the ability to challenge the actions of the government, and if that fails to challenge the laws that permitted the government to take the offending action.

Still, there is evidence that in telecommunications policy the relationship between the Public Utilities Commission and the Legislature has devolved. The rapidly changing telecommunications industry and its customers will be better served by some agreement in how major and minor policies will be set.

## *Delegation vs. Accountability*

**H**istorically, the Legislature has granted significant authority to the PUC to set both broad and detailed policy for the industries within its jurisdiction. Among the purposes of this arrangement was to insulate from day-to-day politics the establishment of regulations that would result in private concerns earning millions of dollars. It also left the task of creating those regulations in the hands of full-time experts in the field.

In creating the PUC during the Progressive Era, California helped to develop the model for that fourth-branch form of government that was widely replicated during the New Deal Era. At the time of the Great Depression, a plethora of federal regulatory commissions were developed for the expressed purpose of making swift and expert decisions affecting the marketplace with the hope of spurring an economic recovery in a number of developing markets.

By intentionally consolidating the legislative and judicial functions of government into single agencies, reformers hoped to increase the efficiency and quality of decision making. The values of fourth-branch agencies are:

- ***Efficiency.*** By vesting the PUC with quasi-legislative and quasi-judicial decision making, the Commission was expected to establish regulations quicker than the Legislature could enact laws and enforce those regulations with more consistency and alacrity than the courts.
- ***Integrity.*** By appointing Commissioners to six-year terms, prohibiting them from conflicts of interest and insulating them from removal for political reasons, the Public Utilities Commission was expected to make decisions free from corrupting influences and with an impartiality toward those with actions before it.
- ***Quality.*** By giving the Commission a focused task and an expert staff, the Commission was expected to make technically sound and legally correct decisions, with the public interest as its lodestar.

One acknowledged cost for this arrangement is reduced accountability on the part of the PUC to the Governor, who appoints the Commissioners but does not have the authority to remove them, and on the part of the PUC to the Legislature, which as the venue for making laws is the primary navigator for state policies.

In the case of the PUC, that accountability was further reduced by severe restrictions on the rights to appeal Commission decisions to the courts -- a measure of independence that government reformers have granted few other fourth-branch commissions.

## *Insulation vs. Isolation*

More recently, the Legislature has not been satisfied either with the decisions the PUC has made or with how those decisions have been made. In a number of instances, the Legislature has initiated on its own or been asked by PUC participants to statutorily establish a policy that the PUC believed was its prerogative to decide. In other cases, PUC participants -- dissatisfied with the PUC's procedures and the extremely limited ability to appeal decisions to the courts -- have appealed to the Legislature for reconsideration of an issue "litigated" at the PUC.

Many of the complaints have resulted from the Public Utilities Commission's procedures -- how it goes about making decisions, how it relies on staff and how Commissioners are involved in the policy-setting process. Other complaints have centered on the decisions themselves -- for instance, the Commission's insistence on regulating cellular telephones and its reluctance to give up control over paging services.

The conflicts are almost inevitable as the PUC seeks to adapt itself to industries that are rapidly changing without having sought statutory clarification of the role that lawmakers would prefer it to fill.

These conflicts also are well illustrated by an instance when the problem was averted. In 1993, the Governor in his State-of-the-State address requested the PUC to develop a road map for determining the feasibility of competition in all telecommunications markets.

The Commission's investigation resulted in its report *Competitive Strength: A Strategy for Telecommunications Infrastructure*. That report resulted in a legislative debate in 1994 and the passage of AB 3606 (Moore) and AB 3720 (Costa) calling for competition at the local telephone market, allowing incumbent monopolies to compete for services they had been restricted from offering and streamlining PUC regulations to encourage competition.

One PUC Commissioner described this policy evolution as "an excellent example of useful synergy between policy initiative and implementation."

This process allowed for the Governor and the Legislature to express a policy preference -- and to sign off on the details of the ultimate policy -- while allowing for the PUC to utilize its expertise to develop the details

### *Policies Before Rules*

In AB 3606, the Legislature was able to express a number of policy preferences before the PUC crafted rules for opening local telephone service to competition.

It declared that competitive markets would yield better prices and services to most Californians than regulated markets, but that the State still had a role in ensuring "that certain societal goals are met," including universal service.

It declared that local telephone companies should be able to enter into the cable television business, but their local networks also should be unbundled to encourage competition.

of the plan and its regulatory authority to implement it. The process helped to restore the accountability for decision making between the Legislature and the PUC, allowing each to play the appropriate role at the appropriate time. But that case is the exception, not the rule.

## ***Routine Accountability***

Several provisions in SB 960 are intended to make the PUC more accountable for the decisions it makes, and begin to establish a better relationship between the Legislature and the PUC.

Beginning in January 1999, the PUC will be required to make an annual statement to the Legislature on the number of cases the PUC took longer to resolve than it said it would when the case began. This provision is intended to push the PUC toward making timely decisions, and to be accountable to the Legislature when it does not.

Also, in March 1997, the PUC is required to submit a report to the Legislature on recommendations about regulations and statutes that should be changed as a result of competition -- an attempt to eliminate the statute-by-statute revisions that are now requested often after a long battle before the PUC, the FCC or in the courts.

These efforts could be expanded -- and the success of AB 3606 repeated -- by establishing an annual reporting and goal-setting process between the Legislature and the PUC. As described for energy policy in Finding 4, the PUC and the Legislature could create an annual ritual of reviewing the PUC's accomplishments of the last year and setting goals for the next year.

GTE advocates that the PUC and the Legislature set goals on an annual basis -- for new policies the PUC would pursue and old programs it would drop. The following year, the Commission's efforts would be assessed based on outcome-oriented measurements: How did the efforts affect consumer prices and services? Based on that assessment, the Legislature and the Commission would set goals for the next year -- developing over time a constructive relationship that is better able to withstand individual special interest pressures.

Such a process should enhance the characteristics that Californians expect from fourth branch commissions -- efficiency, integrity, and quality -- while restoring the accountability that some critics believe has been lost. The process also could provide predictable procedures for setting policies concerning a dynamic industry -- discouraging market players from venue shopping between the PUC and the Legislature and encouraging consistent policy making favored by investors.

## ***Recommendations***

***Recommendation 7: The Governor and the Legislature should enact legislation requiring the Public Utilities Commission, as a precursor to the annual review and approval of its budget, to collaborate with the Legislature to review telecommunications policy directions and past performance and establish specific goals that the Commission will pursue in the coming year.***

While the PUC was intended to be insulated from day-to-day politics, it cannot operate in a vacuum. Over the long term, the legitimacy of fourth-branch commissions to chart significant policy changes will be enhanced by routine reality checks from elected legislators. Similarly, while the PUC is given the authority to make tough decisions day in and day out, the legitimacy of those decisions will be enhanced by an annual public accounting of PUC's policy choices.



# Transportation

- ❖ *While federal policies have virtually eliminated economic regulation of competitive transportation providers, the State maintains vestiges of rate-setting that are known to increase consumer prices.*
- ❖ *Safety and licensing are the prevailing State functions concerning transportation providers, and those duties are shared by the PUC and the State's transportation agencies.*
- ❖ *Rail safety and rail planning are closely related issues, but those duties are split between different State agencies, and in some cases are duplicated.*



# In Whose Interest?

**Finding 8: Some of the PUC's transportation regulatory activities are remnants from an era when industry asked for government intervention as a shield against the rigors of competition. Those regulations, disguised as consumer protection, can have the effect of raising prices without a commensurate benefit to the public.**

**T**he PUC has been regulating the rates of transportation providers for more than a century. In the beginning the PUC's clear purpose was to guard the public against the abuses of the powerful railroad interests. But priorities shifted with the Depression when the trucking industry asked for rate regulation to protect companies from cutthroat competition, and government, with an eye toward stabilizing the national economy, responded.

As a consequence, the Public Utilities Commission, like commissions nationwide, strove to fulfill dual and conflicting mandates -- to protect the public and at the same time to protect regulated companies. With this contradictory mission the PUC has at times put the interests of carriers first -- redefining the public interest through the lens of what is good for industry. As a result, many of the companies under the PUC's regulatory umbrella have come to see the agency's main task as preserving industry well-being.

The PUC is now pre-empted by federal law from regulating rates for railroads and trucks. But the PUC has yet to abandon rate setting for other carriers, and it has a number of other requirements that discourage new entrants and can lead to higher consumer prices.

## *A Decade of Deregulation*

**D**eregulation of transportation carriers was not driven by industry, but by consumers. Consumer advocates fought for deregulation before Congress because they believed that consumers stood to benefit from open competition among transportation providers. They convinced policy makers that when government set rates in markets where competition existed or was possible, the effect was to raise prices and limit services. And they convinced policy makers that just as trucking had eroded the monopoly of the railroads, in other transportation markets consumers increasingly also had choices -- among buses, trains, airplanes, taxi-cabs, limousines and shuttle buses.

One lesson from transportation deregulation is that consumer welfare can be diminished as much by too much regulation, as by too little -- and sometimes simultaneously within the same industry. When deregulation is complete but some providers maintain market power, prices can rise. When deregulation is incomplete and competitors are hindered by government rules, prices can also rise.

Airline deregulation illustrates the first type of failure. In prohibiting all rate regulation regardless of the level of competition, the federal government erred on the side of the market -- hoping that new market players would enter routes where prices were too high. That policy has subjected customers in under-served markets, at least temporarily, to high prices charged by sole providers. The benefits of deregulation have been reaped by air travelers between major destinations where competition is fierce. In effect, the captive customers of sole providers have subsidized the lower prices available to air passengers in high traffic areas. Where this kind of rate inequity exists in California, the PUC is prevented by federal deregulation of air transportation from intervening on behalf of captive customers.

The second failure of transportation deregulation -- the failure to completely deregulate rates when open competition might lower prices -- can have the effect of limiting new entrants and encouraging market players to charge the same price. In the wake of price deregulation, and

### *For Example, Airline Deregulation*

The Director of the University of San Diego Center for Public Interest Law, writing in the Spring/Summer 1992 issue of the *California Regulatory Law Reporter*, explained how deregulation of the airline industry has had uneven benefits for consumers:

*Let's take an example. On March 6, 1990, it cost \$480 to fly round-trip from San Diego to Sacramento. One could fly to Europe for less than it cost to go from California's second largest city to its capital. The market was a tight oligopoly with US Air as price leader. Southwest Airlines was virtually the only competitor "on the make" and willing to price independently. But Southwest did not then serve San Diego-Sacramento. A lack of airport gates in Sacramento was one impediment. But in markets where Southwest offers competition to these same carriers, fares are one-fourth to one-third the per passenger mile rate of the \$480 San Diego-Sacramento charge.*

in trying to balance the interests of industry and consumers, the PUC has retained three requirements from its economic regulations of years past:

**1. *Passive Rate Regulation.*** The PUC still keeps a hand on rates charged by household goods movers and some passenger carriers. The Commission sets the maximum rates movers can charge for a menu of specified services. Under legislation enacted in 1995, the maximum rates are adjusted annually. The PUC also requires scheduled bus lines and shuttle services to file tariffs specifying rates. The Public Utilities Commission allows passenger carriers to make small rate changes within a “zone of rate freedom,” but approves significant changes in rates only if it first determines that the carrier faces adequate competition.

**2. *Financial Reports.*** The Commission requires carriers to file two kinds of financial reports. New carriers must file information to prove they have the financial wherewithal to provide a proposed service. And existing carriers must file detailed financial reports every year -- solely to determine the fee the company must pay to the PUC.

**3. *Certificates of Public Convenience and Necessity.*** Every passenger carrier who wants to enter a market under the Commission’s jurisdiction must apply for a certificate of public convenience and necessity. In order to obtain a certificate, applicants must show the PUC that they will not adversely affect other carriers in the area. They also must notify any carriers already operating in the market of their proposed entry, effectively inviting protests against the potential competition. The Public Utilities Code calls for the PUC to grant certificates only if it finds that carriers already serving the area are not providing satisfactory service. While the PUC is moving toward an “open entry” policy for new service providers, it still retains the public convenience and necessity filing requirements that allow incumbent providers to challenge the applications of potential competitors.<sup>82</sup>

## *From the Consumer’s Perspective*

Representatives of some companies regulated by the PUC argue that maximum rate setting is necessary to give consumers a way of comparing the cost of services from one company to another. But a number of studies in various industries have shown that in competitive markets, passive rate setting and other kinds of economic regulation lead to higher prices.<sup>83</sup> The PUC’s passive rate setting, financial reporting and public convenience and necessity rules are vulnerable to this charge:

***Passive Rate Setting.*** Researchers have found that setting maximum rates undermines competitive pricing by encouraging companies to charge similar amounts for like services. Passive rate setting takes a number of forms across the country. Several states exempt the moving industry from antitrust laws and allow moving companies to specify rates as a group.

At the federal level, interstate movers are allowed to define maximum rates for designated services through the Household Goods Carriers Bureau, a "rate bureau" made up of moving companies. The bureau publishes the rates in a tariff and petitions every year for usually automatic approval from the Surface Transportation Board.

In California the PUC sets maximum rates movers may charge. Until recently the moving industry had to apply to the PUC and go through a hearing process whenever it wanted to raise rates. But in 1995 the moving industry, complaining to the Legislature that this process was too protracted, managed to have the law changed.

Under legislation sponsored by movers and effective in January 1996 (AB 877, Conroy), the maximum rate will be adjusted automatically every year according to an industry "productivity index," yet to be defined. A former PUC Transportation Division Chief explained the rationale:

*The industry productivity factor will be adopted to allow industry as a whole to get an increase. The more efficient you are, the more you'll be making. It's like incentive rate making.<sup>84</sup>*

Said the president of the California Moving and Storage Association, which represents household goods movers: "The automatic rate review is a slam dunk for us. It takes only a few hours."<sup>85</sup>

California moving industry representatives maintain that the rates movers charge are typically 10 to 20 percent below the maximum rates. Nonetheless -- and by whatever mechanism it is carried out -- maximum rate setting encourages competitors to charge similar prices, reducing the market's downward pressure on rates.

Customers may indeed be able to compare prices for similar services from company to company, but they are likely to find that the rates are all the same, and that they are all high. The Director of the University of San Diego Center for Public Interest Law told the Little Hoover Commission:

*Where truckers are allowed to set rates in concert, and where public filing of rates prior to or at the time of effective charge is allowed, the state creates a ready-made mechanism for private price fixing.... The fact of common gain through price increases becomes a part of the price setting fabric.<sup>86</sup>*

### ***The Role of the Regulator***

The PUC's role of protecting both the consumer and the transportation industry has caused confusion at times about which role takes precedence -- and even requires the occasional reminder that both roles exist. The confusion is reflected in this comment from the owner of Fleetwood Limousine Company to the Governor's Deregulation Task Force:

*Whatever program is selected, the agency responsible must be concerned with protecting the public, as well as the limousine operator.*

Researchers have found the same principle in telecommunications, where early price competition among long distance competitors was replaced by nearly uniform rates across the industry.<sup>87</sup> Because rate changes and discount schemes have to be approved by the Federal Communications Commission, competitors are signaled in advance to changes and can respond by raising or lowering their own prices. One pair of researchers described the dynamic from the business perspective:

*Adam Smith suggested that businessmen rarely meet but to fix prices. A modern Adam Smith might suggest that businessmen prefer the regulatory market over true competition since the regulator has the power to affect the market outcome without exposing the firm to the risk of antitrust prosecution.<sup>88</sup>*

The PUC's rate restrictions on passenger carriers similarly has little benefit to consumers. The requirement that rate tariffs be filed and that only minor rate changes be allowed assumes in advance the need for rate regulation. The PUC looks for competition only after the fact. A better approach might be to determine where competition exists and cease all economic regulation in those areas. If residents in a remote or under-served area remain captive customers of a sole provider, the PUC might then be justified in overseeing rates.

**Financial Reporting.** Requiring new companies to prove they have the financial resources to provide a proposed service is another remnant of the PUC's economic regulation of monopolies. The requirement may have some value in preventing customers from being victimized by a company's inadequacy, but there is little evidence that protection is needed in bus, shuttle or moving services more than any other industry.

There also is little evidence that the PUC's test of financial fitness is effective at keeping under-financed companies from operating. One reason is that the financial fitness test conflicts with the PUC's open entry policy for new providers. Representatives of limousine and airport shuttle services said that too often the open entry policy hurts the industry by licensing companies that soon go out of business.

Requiring incumbent companies to file extensive annual financial reports for the sole purpose of assessing PUC fees based on company revenues began when the PUC had a heavy hand in determining those revenues. The financial reporting requirement adds to the costs ultimately borne by consumers while adding little value to the services provided.

One company president said it takes her company 30 hours each year to assemble the data requested to determine the fee. She questioned how much of the information is really needed:

*It is my experience that hardly anyone looks at these reports nor even knows if they are submitted. (A recent experience by a colleague brought to light a company who had not filed an annual report since 1992!) If the CPUC needs figures to validate a*

*transportation company's worthiness to stay in business, one only has to require an annual reporting of their financial statements and a copy of their corporate structure.<sup>85</sup>*

**Certifying Public Convenience.** The PUC has required Public Convenience and Necessity Certificates in nearly all of the industries it regulates. The most common reason for the certificates has been to determine whether the capital expansion proposed by a monopoly would provide enough benefit to warrant the additional expenses imposed on captive customers. When the application was from a potential competitor, the PUC used the certificate process to determine whether a new applicant would undermine the economic position of the incumbent, which was seen as counter to the public interest.

In today's transportation climate, the certificate serves principally to protect incumbents from competition and is inconsistent with the goal of encouraging new market entrants. Not surprisingly, licensed carriers favor this requirement. But the public does not benefit from limiting the number of carriers offering services in a given market simply to avoid harming incumbents.

In a competitive market, the entry of virtually any new provider should be assumed to be in the interest of public convenience and necessity because competition leads to lower costs and improved service.

To promote competition in electricity generation, the PUC has advocated that new power plants not have to pass any kind of needs test and that new market players be held to minimal entry standards.<sup>90</sup> But at the same time the PUC maintains an antiquated entry requirement for companies that want to drive passengers to the airport.

Besides being anti-competitive, there are indications that the PUC's economic regulation of carriers also may be ineffective, in that many upstart companies operate "illegally." Household movers, limousine companies and others complain that the PUC does not track down unlicensed operators and that competition from illegal operators hurts business. One limousine company owner complained to the Commission that there was "too much competition" in his industry and that the PUC should do something about it.<sup>91</sup>

### ***The Industry View: One Example***

The president of the Marin Airporter Company, an airport shuttle service, complained in testimony to the Little Hoover Commission that she had to spend \$50,000 fighting a competitor's application for a certificate of public convenience and necessity.

Her specific complaint was that the effort failed and the competitor was allowed to operate, but that the new company went out of business five years later.

It is difficult to know how that battle affected the ability of the new provider to survive, and whether the consumers in that market would be better off today if they had two providers to choose from.

An example of how the PUC's handling of carriers can work against the public interest is in the regulation of airport shuttle vans -- ironically one of the most competitive areas of passenger service. Airport operators, usually county officials, are frustrated because terminals are jammed with large numbers of vans and limousines jockeying to pick up customers. The PUC, trying to pursue pro-competition policies, is reluctant to help by limiting market participants.

### *In the Case of Sacramento Airport*

At Sacramento International Airport, county officials were concerned about traffic congestion and barraged by consumer complaints about price gouging and poor shuttle service. They responded by requesting potential competitors to submit proposals to provide services that met minimum rate and service standards. When only one company met the specifications, it was granted preference in serving the airport. The PUC -- objecting because airport customers now would be served by a monopoly provider -- then stripped the company of its "zone of freedom" right to make minor rate changes without PUC approval, even though the county airport officials had found the rates acceptable.

Some airports have tried to solve the problem by contracting with selected companies to provide the passenger shuttle services. State law specifically allows airports to enter into exclusive contracts with shuttle companies, even if the contracts limit competition. By law, the airport can define the services expected and otherwise control shuttles operating on airport property. But the PUC, with its jurisdiction over passenger carriers, can step in to render the contracts meaningless.

The Commission reserves the right to judge a company's rates and "fitness" to serve the public. If the company fails the PUC's test, the PUC can assert control over the rates or revoke the company's authority to operate.

## *Creating New Standards*

In the transportation market, taxi-cabs, limousines, chartered buses, scheduled bus lines, and shuttle vans are all vying for the same customers, but operating under different regulatory schemes -- with taxi-cabs licensed by cities and other carriers under varying requirements of the PUC as well as the California Highway Patrol and other agencies.

It is difficult to see what value the PUC's filing requirements and passive rate setting add to the health of this market. Eliminating these regulations would allow customers to more fully benefit from competition by encouraging new entrants and requiring market players to more aggressively price their services.

## ***Recommendations***

### ***Recommendation 8: The PUC should cease all transportation-related activities.***

Policy makers at the federal and the state level have determined that competition, not regulators, should set prices for transportation providers. Preserving remnants of economic regulation -- such as issuing certificates of public convenience and necessity for new providers, posting tariffs and requiring detailed financial reports -- can reduce competition and increase consumer prices without providing significant consumer benefits.

# Safety Regulation

**Finding 9: The PUC's transportation safety and insurance functions overlap with the duties of the California Highway Patrol and the Department of Motor Vehicles. The overlap results in unnecessary regulation and contributes to gaps in safety.**

**A**s rate setter and consumer watchdog -- as well as industry guardian -- for virtually the entire transportation sector, the PUC was a logical place to consolidate most of the State's regulation of buses, trucks, rail and other common carriers in the early days of the century.

The PUC's historic rate regulation of transportation providers also put it in a strong position to impose licensing and safety regulations to serve the customers of both common carriers and others sharing the State's roadways. Its judicial authorities were swift mechanisms for dealing with violators.

But since the PUC's role in economic regulation has been pre-empted at the federal level, it is appropriate to reassess the agency's remaining roles in licensing and safety.

The State has an agency whose primary function is transportation. And within that agency, there are departments whose primary duties are licensing drivers and enforcing safety laws. While it is possible to carefully define responsibilities to avoid technical overlaps, that effort often avoids placing functions with the agency most capable of performing them.

## *Gaps and Overlaps*

Two aspects of the PUC's comprehensive regulation -- liability and safety -- have enduring public benefits and have survived beyond rate deregulation. The PUC uses its licensing authority to require companies to have driver and vehicle safety programs and to ensure that operators carry liability insurance.

The PUC maintains that these functions require its expertise. But many of the PUC's activities duplicate functions of departments in the Business and Transportation Agency -- particularly those of the California Highway Patrol (CHP) and the Department of Motor Vehicles (DMV).

The PUC's liability program requires moving vans, buses, limousines and shuttle buses to maintain adequate liability insurance as a condition of operating in the State. Until January 1, 1997 that requirement also applies to commercial trucks. Legislation effective that date will end PUC jurisdiction over trucking companies.

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***For all of its authority over vehicle safety, the PUC has no vehicle inspectors and does not inspect vehicles.***

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The PUC also requires intrastate carriers (but not private companies carrying their own goods) to have workers' compensation insurance. Insurance companies are required to notify the PUC when a company's insurance is about to lapse, and the PUC can suspend or revoke a company's operating license if it fails to maintain its insurance or safety programs. The PUC's safety program consists of requiring companies to have a preventive vehicle maintenance program in place and to subscribe to the Department of Motor Vehicles driver "pull-notice program," which gives companies access to drivers' records.

Because the PUC has an enforcement staff of only 34 in its six field offices statewide, it relies on industry informants to enforce these requirements and to make sure that all carriers operating are licensed. When the PUC certifies a company as having met the insurance and safety requirements, it issues a "Cal T" number for the company to display on its vehicles. Licensed companies, anxious to eliminate "illegal" operators that might be charging lower rates, report companies that appear to lack a Cal-T number.

The California Highway Patrol, meanwhile, has its own safety programs. The CHP conducts regular inspections of bus and truck terminals in which it checks driver logs, makes sure the company has adequate vehicle maintenance and driver training programs, checks accident rates and inspects vehicles for safety.

The CHP also conducts routine roadside inspections of all trucks operating on California highways -- requiring every truck over 10,000

pounds to be inspected once every three months -- and inspects buses in occasional highway "strike force" operations. The CHP (with some exceptions) has no jurisdiction over vehicles with fewer than 11 seats, which takes in nearly all limousines and airport shuttle buses. The CHP also does not have access to the PUC's insurance records for checking either at terminal inspections or roadside stops.

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***The jurisdictional divide leaves at least one serious public safety gap. Shuttle vans -- which transport between 8 million and 12 million passengers a year in California -- may never be inspected.***

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For all of its authority over vehicle safety, the PUC has no vehicle inspectors and does not inspect vehicles. Occasionally the PUC accompanies the CHP on "surprise inspections" at places where buses and shuttles congregate -- at airports, national parks and Disneyland on Prom Night. In these instances, the CHP inspects the vehicles while the PUC provides the jurisdictional authority for the inspection. The CHP conducts similar surprise inspections at airports, in those instances using the jurisdictional authority of airport police.

The CHP and the PUC maintain that there are no overlaps in their safety efforts -- because the CHP deals with actual vehicles and drivers and the PUC deals with companies. At best, however, the present system has the PUC, CHP and DMV performing parallel functions and requires the various agencies to coordinate efforts to avoid overlaps and gaps.

And even with all three agencies involved, the jurisdictional divide leaves at least one serious public safety gap. Because the CHP has no jurisdiction over vehicles carrying fewer than 11 passengers and because the PUC does not inspect vehicles on its own, one large class of commercial vehicles may never be inspected at all.

Shuttle vans -- which the PUC estimates transport between 8 million and 12 million passengers a year in California -- are not included in the CHP's terminal and roadside inspections. As a result, they may never be inspected unless they are examined by airport police or caught in a surprise joint inspection. As a practical matter, many shuttles are able to elude even these inspections by leaving airport grounds whenever inspectors appear.

To further complicate matters, local police agencies, DMV, the State Board of Equalization, and Department of Transportation all have some role in regulating commercial vehicles. The Commissioner of the Highway Patrol testified that while cooperation among agencies is good, the system could be better:

*Some minor overlaps inevitably occur, but the system generally has worked out the kinks and each agency understands and carries out its responsibilities. Industry would echo that conclusion, we think with the possible footnote that the PUC has been characterized as lacking responsiveness.<sup>92</sup>*

One additional factor soon may affect the State's safety oversight of transportation carriers. A proposal now under debate at the federal level would incorporate insurance records for both interstate and intrastate transportation carriers into a centralized national database. Once the database is in place, the trucking industry is expected to propose that the authority of states to prevent uninsured carriers from operating be removed. If the move is successful, state oversight of carrier liability insurance could end by 1999.<sup>93</sup>

## ***Legislative Changes***

**A**fter Congress deregulated intrastate trucking in 1994, ending state control over rates, the Governor's Deregulation Task Force was convened to decide how the State should respond. The Task Force, which was made up of industry and state agency representatives, concluded that the PUC's licensing and insurance authority over all commercial vehicles except for household goods movers and passenger carriers, should be transferred to the California Highway Patrol. The Task Force further recommended that a Motor Carrier Advisory Committee be set up to look at more long-range issues, including transferring all trucks and passenger carriers remaining under PUC oversight to the CHP.<sup>94</sup>

Representatives from the trucking industry followed up by sponsoring legislation. The truckers were motivated partly by the fact that the fees they were paying to the PUC exceeded what the PUC was spending to regulate the industry. Legislative hearings on the issue revealed that in 1995 the PUC collected \$20 million in fees from trucking companies, but spent only \$9 million on transportation issues.<sup>95</sup>

The legislation that resulted -- AB 1683 (Conroy), which will become effective in January 1997 -- differed from the task force recommendations in two ways.

First, instead of consolidating the PUC's licensing and safety functions at the CHP as the task force recommended, the new law divides those responsibilities between the CHP and the DMV. Under AB 1683, the CHP will take over the PUC's function of checking trucks for liability and workers compensation insurance, adding those requirements to its truck terminal inspections. The DMV will enter the insurance information into a database to which the CHP will have access. The DMV will issue companies a motor carrier permit, which will be the equivalent of the PUC's license to operate a commercial vehicle.

Second, instead of following the long-term recommendation of the task force that both trucking and passenger carriers eventually be moved out of the PUC, the bill transferred only trucking carriers. According to the executive vice president of the California Trucking Association, the exclusion of passenger carriers was strategic:

*This was a tough bill, a consensus-building bill. As it was it took us two years to get the bill through. The (federal) pre-emptive legislation dealt only with freight transportation and we made a decision to stick close to the federal deregulation guidelines. If the bill had included passenger carriers it would have taken four years to get it passed.<sup>96</sup>*

Household goods movers, who were not included in trucking deregulation at the federal level, also opted to exclude themselves from AB 1683. According to the president of the California Moving & Storage Association, the reason is that the moving industry needs the consumer protection oversight of the PUC because consumers are unsophisticated about using household moving services and moving is stressful. But here again the public interest is confused with protecting industry :

*Movers want to stay with the PUC because the PUC knows how to regulate. They go after the unlicensed movers who take business away from licensed movers. They understand the vulnerability of the moving industry to consumer complaints.<sup>97</sup>*

## ***Realigning Responsibilities***

The State has at least three options for realigning the PUC's safety, liability and consumer protection functions:

**1. *Change the CHP's Jurisdictional Threshold.*** One solution would be to expand the CHP's jurisdiction from the present 11-passenger limit to all commercially operated passenger vehicles except taxi cabs, which are under local authority. This would leave the PUC with authority to check for liability insurance and other safety programs and to issue an operating license. However it would bring shuttle buses into the CHP's terminal inspection program and also allow the CHP to inspect these vehicles on its own authority at airports, in roadside stops and at other locations without PUC involvement. Even without putting shuttle buses under CHP jurisdiction, the PUC role in inspecting shuttle buses adds little value since airport police have authority to inspect these vehicles on their own and to prevent vehicles that fail inspections from operating on airport grounds.

**2. *Shift Passenger Carrier Jurisdiction.*** A broader solution to eliminating both gaps and duplication would be to follow the recommendation of the Governor's deregulation task force and build on the model of AB 1683 by transferring passenger carrier oversight to the CHP and the DMV. That move would allow the CHP to include shuttle vans in its terminal and vehicle inspection programs, take over the PUC's function of checking for insurance and carry out enforcement through the courts or by instructing the DMV to revoke a company's motor carrier permit. The PUC argues that its authority over passenger carriers is necessary because it is the only state entity with the power to revoke an operating license. But this authority could be replicated at DMV, as

trucking companies under AB 1683 -- particularly since DMV issues licenses and maintains records for drivers.

**3. Consumer Protection.** Providing a method for resolving consumer complaints also serves a genuine public need, but there is no reason this need must be met by the PUC. Despite moving industry claims that the public needs special protection from unethical moving companies, there is no persuasive evidence that the problems of customers of moving companies -- or passenger buses -- could not be addressed by another governmental entity or by the same remedies afforded in any other business transaction. The president of the California Moving and Storage Association (CMSA), acknowledged in a letter to the Little Hoover Commission that consumer protection related to the moving industry could be provided by another agency:

*Another agency, a restructured CPUC and/or a combination of the above could possibly perform the necessary regulatory functions. However, CMSA would strongly suggest that nothing less than the existing level of expertise be utilized.<sup>98</sup>*

Transportation deregulation offers the State the opportunity to realign its regulatory programs to provide the greatest possible benefit to the public interest and safety. Seven other states provide a model. All of these states rely on transportation agencies outside their public utilities commissions to perform the transportation oversight responsibilities assigned in California to the Public Utilities Commission.<sup>99</sup>

## ***Recommendations***

***Recommendation 9-A: The Legislature and the Governor should enact legislation transferring the safety and liability regulation of all commercial highway carriers to the California Highway Patrol and the Department of Motor Vehicles.***

Common sense and economic realities prompted the Legislature in 1996 to move safety and licensing of truckers to the CHP and the DMV. Common sense dictates that the same functions for other transportation providers be transferred to those agencies as well.

***Recommendation 9-B: The Legislature and the Governor should enact legislation putting minivans that are used to carry passengers commercially under the same safety oversight as larger passenger vehicles.***

Shuttle vans represent an area where economics and convenience actually work in favor of the State's policies of discouraging single occupancy vehicles. The State should take advantage of this trend by

providing shuttle passengers the same level of safety as in other commercial passenger carriers.

***Recommendation 9-C: The Governor and the Legislature should enact legislation moving the PUC's consumer protection functions concerning household movers to the Department of Consumer Affairs. A sunset review should be performed to determine if there is a continuing need for this specialized oversight.***

The State has an enduring interest in making sure its citizens are not cheated or victimized by thieves. The State pursues this interest daily with generalized law enforcement and consumer protection agencies. There is nothing to indicate that a similar level of state involvement on household moving issues will prove inadequate.



# Rail Safety

**Finding 10: As the PUC's role as a rate setter for railroads has been eliminated, it is left with railroad safety functions that are more related to the core competencies of transportation planners and accident investigators than to those of an economic regulator.**

**T**he federal government has pre-empted the states from economic regulation of railroads and has virtually pre-empted the states in safety regulation as well. Nevertheless, the PUC retains some jurisdiction over safety for both heavy rail and rail transit systems.

Disasters like the 1991 Southern Pacific derailment into the Sacramento River at Dunsmuir have galvanized interest in maintaining a state role in safety. But at issue is how the State can best fill that safety role.

While the freight rail industry is experiencing rapid consolidation, passenger rail service is experiencing a resurgence.

Essentially all of the new passenger providers, however, are public agencies that require different kinds of oversight than private providers and are already working closely with state and federal transportation agencies to plan, build and operate safe and efficient systems.

And finally, the PUC continues to play a role in rail crossing safety, a role that transportation providers also fill -- providing opportunities for realigning functions.

## ***The PUC's Oversight of Railroads***

The Public Utilities Commission was initiated as a multi-purpose regulator of railroads at a time when railroads held a monopoly on cargo and passenger transportation. The PUC set rates, policed for discriminatory fares and set and enforced safety standards. Other modes of transportation have long ago eroded the railroad monopoly and the ability of railroads to take advantage of captive consumers. Today, the federal government has primacy on nearly all matters concerning non-government railroads. The PUC retains four rail-related functions:

**1. Freight and Passenger Rail Safety.** The PUC is responsible for inspecting heavy rail systems using inspectors trained and certified by the Federal Railroad Administration to make sure tracks, equipment, signals and operations meet federal standards. The Commission also investigates rail accidents. Under state law passed after the Dunsmuir spill, it identifies sections of track vulnerable to accidents and applies local rules concerning reconstruction and operations on those sections.

**2. Transit System Safety.** The PUC is responsible for reviewing the safety programs of the State's six rail transit systems: the San Francisco, BART, Metro Rail, San Diego, Santa Clara and Sacramento light rail systems.

**3. Grade Crossing Safety.** The PUC makes sure that rail-highway crossing and crossing warning devices are operated and maintained safely and it conducts engineering reviews of new or modified rail-highway crossings. In conjunction with the California Department of Transportation, the PUC sets a priority list for grade crossing improvement projects to be completed with federal funds.

**4. Mergers and Abandonments.** The PUC retains a minor advisory role in economic oversight by making recommendations to the federal Surface Transportation Board in response to railroad mergers and track abandonments.

## ***Overlapping Roles***

The State's role in rail safety is complicated by the overlapping responsibilities of the PUC and Caltrans. This is particularly true in funding safety upgrades for the State's 9,700 public highway-rail crossings.

Most of these projects are paid for by "Section 130" funds -- federal money provided by the Highway Safety Act of 1973. The PUC takes the lead in establishing the priority list for crossing upgrades to be funded. To create the list, the PUC consults with railroad officials and local communities.

Caltrans -- after talking to railroad officials and local communities independently -- reviews the PUC's list and recommends modifications. After the list is finalized, Caltrans prepares a service contract with the railroad to have the work done.

The two agencies use a similar process for determining which crossings should be closed to accommodate high speed trains, and for projects to separate rail crossings from highways.

The need for the two agencies to coordinate activities and agree on Section 130 projects can slow the process to a stand-still. Nearly 1,400 crossings were upgraded under the program between 1973 and 1993 -- about 70 a year. But according to Caltrans officials, in 1994 and 1995 the State managed to complete only about 30 projects a year -- while the PUC and

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***In 1994 and 1995 the State managed to complete only about 30 [rail crossing upgrade] projects a year while the PUC and Caltrans wrestled over who had final say over project priority.***

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Caltrans wrestled over who had final say over project priority. The problem was further complicated by a turf battle within Caltrans.

Not only can such inter-agency disputes delay projects, but the need for the two agencies to coordinate efforts can compromise safety where duties are divided and coordination falls short. One Federal Highway Administration official told the Little Hoover Commission:

*In an ideal world there would be only one agency to handle the program. (Having two agencies) can be a big problem in places like Oakland where there are a lot of railroad crossings over local streets. The PUC interfaces with the railroads while Caltrans interfaces with cities and counties. Traffic lights are not the PUC's bailiwick.<sup>100</sup>*

Other states avoid the problem by giving one agency responsibility for handling the crossing upgrade program. In Texas, for example, the Department of Transportation prepares the priority list for federal rail crossing upgrade Section 130 funds using a simple state formula based on such factors as the number of vehicles per day, the number of trains in a 24-hour period, average speed of the trains and the number of train accidents at the location in the past five years.

The Texas Railroad Commission -- whose safety functions are similar to those of the California PUC -- has no role in funding rail-highway crossing upgrades. Texas officials further speed the upgrade funding process by providing the 10 percent matching funds required of local communities. By this method, Texas is able to funnel \$14.6 million in crossing upgrade funds and to complete between 150 and 175 projects each year.<sup>101</sup>

North Carolina operates a similar system, with the State Department of Transportation using a federal formula to prepare the priority list with no

involvement by the public utilities commission. That state completes between 75 and 80 crossing safety upgrade projects a year.<sup>102</sup>

In contrast, because of the disagreements between the PUC and Caltrans, officials from the Commission's Rail Division say they have decided to limit the PUC's list of eligible projects to the 30 crossings they deem most needed. As a result, California can now complete no more than 30 projects a year, even though, according to the PUC, 1,020 public rail-highway crossings in the State presently need upgrading to federal standards and local matching funds have already been authorized for 740 of those crossings.<sup>103</sup>

## ***Coordinating Rail Safety with Rail Planning***

The growing interest in rail and the State's interest in better incorporating rail transport into statewide transportation raises the issue of how the State can best align its planning and safety goals. Most often the public interest is best served when those functions are closely coordinated. In addition, most new rail services are being provided by other government agencies -- increasing the need for coordinating efforts among state, regional and local authorities.

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***“Railroad warning signals that ‘meet the standards’ for rail inspectors might not adequately consider the demands of highway traffic, and traffic signals that seem adequate to highway engineers might pose problems for rail operations.”***

***U.S. Department of Transportation***

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***The PUC's role in rail planning.*** The only voice the PUC has in rail planning is its minor advisory role in rail mergers and track abandonments. Responsibility for statewide transportation planning for both freight and passenger rail rests with the Caltrans. Although the department's involvement in private freight rail planning is limited, the department nonetheless is charged with coordinating the statewide transportation system. The department is required by federal law to participate in cooperative passenger rail planning efforts with the fifteen regional planning bodies in California and to assess the impact of proposed projects on state transportation.

Legislation signed into law in 1996 grants local jurisdictions the authority to enter into joint power agreements to operate intercity rail systems. But most local jurisdictions have shown little interest in taking on that responsibility, fearing that the new law requires local governments to make up any future funding shortages. In any case, Caltrans is expected to have a continuing oversight role for passenger rail in the State's three intercity passenger corridors.

A 1996 U.S. Department of Transportation report entitled “Accidents That Shouldn't Happen,” underscores the need for rail safety considerations to be incorporated into planning. The report said its

investigation pointed to the need for “coordination of warning signal inspections, track and highway maintenance,” and better coordination in setting standards and designing highway-rail crossings. The report pointed out:

*Railroad warning signals that “meet the standards” for rail inspectors might not adequately consider the demands of highway traffic, and traffic signals that seem adequate to highway engineers might pose problems for rail operations.<sup>104</sup>*

On the larger scale, it makes sense for safety to be integrated into planning for both passenger and freight rail systems, particularly with the need to improve connections statewide among buses, trucks, automobiles and rail and to increase capacity at major freight rail hubs.

A June 1996 report prepared for Caltrans by a steering committee made up of government and industry representatives, including representatives from the PUC, came to a similar conclusion. That report, the “California Trade and Goods Movement Study,” pointed to “duplicative, confusing, and overlapping regulations and procedures” among government agencies as a principal impediment to moving freight efficiently in California. Noting that 107 million tons of freight were transported by rail within and through California in 1992, the committee called for a consolidated transportation planning process and streamlined state regulations. The task force cited traffic congestion as a key problem limiting access to seaports, airports and intermodal facilities, and hampering delivery of time-sensitive shipments. It called for improved corridor management resulting in better connections among transportation modes.<sup>105</sup>

### ***Planning Prevents Accidents***

A U.S. Department of Transportation Grade Crossing Safety Task Force, in its March 1996 report, “Accidents That Shouldn’t Happen,” pointed to the implications for safety when coordination fails. That report prompted by the collision of a commuter train and a school bus transporting 35 high school students in Fox River Grove, Illinois, noted:

*The principal finding of this report ... is improved highway-rail grade crossing safety depends on better cooperation, communication, and education among responsible parties if accidents and fatalities are to be reduced significantly.*

The federal Intermodal Surface Transportation Efficiency Act, which has set aside \$155 billion to upgrade the nation’s surface transportation system, also stresses improved links among highways, rail, air and maritime facilities. Passenger rail planning raises similar issues, with the need to coordinate passenger travel among intercity and commuter rail, automobiles, buses and airports.<sup>106</sup>

From an industry perspective, the best place to house safety and planning responsibility for rail is in an agency that understands how railroads operate -- what is needed to move freight so it can connect efficiently with trucks, ships and air cargo facilities and generate profit.

The Business, Transportation and Housing Agency and the PUC have discussed transferring the Commission's rail safety activities to the agency. The discussions were prompted by the Governor's "California Competes" initiative to consolidate duplicative regulatory functions. The Undersecretary of the Business Transportation and Housing Agency concluded that:

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***From an industry perspective, the best place to house safety and planning responsibility for rail is in an agency that understands how railroads operate -- what is needed to move freight so it can connect efficiently with trucks, ships and air cargo facilities and generate profit.***

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*The rail safety divisions of the [PUC] would be more appropriately located under the BT&H Agency.... Rail safety could be improved by the consolidation of [PUC] rail safety activities with the Department of Transportation's Rail Division through increased coordination and communication of rail engineers and safety inspectors....Transferring the [PUC] rail safety divisions to the BT&H Agency will improve policy coordination with other transportation issues statewide.<sup>107</sup>*

The Undersecretary went so far as to identify a home for the PUC's rail-related employees in Caltrans' Oakland office.<sup>108</sup>

For the PUC, the value of such a change would be to reduce workload, free up the time of staff and Commissioners and enable the PUC to concentrate on the single discipline of overseeing the dynamic competitive telecommunications industry.

## ***Recommendations***

***Recommendation 10: The Governor and the Legislature should transfer the PUC's rail planning and safety functions to the Business, Transportation and Housing Agency.***

The precise form the new consolidated program will take should be based on a thorough review of how to best link rail safety with statewide rail planning and how to best coordinate funding of safety projects within Caltrans to avoid the conflicts that have slowed project completion in the past.

# Water

- ❖ *Private water suppliers are required to meet increasingly stringent water quality standards and are expected to stretch existing supplies with efficiency technologies -- public policies that require additional investment and accommodating rate-setting regulations.*
- ❖ *Small water companies -- some of whom do not participate in PUC proceedings -- have a particularly difficult time raising the revenue to make needed investments and the State has not developed an adequate strategy for helping those captive consumers.*



# Finding the Right Venue

**Finding 11: While the rates charged by private monopoly water providers still need government scrutiny, the greater public interest lies in ensuring adequate and safe drinking water supplies -- challenges that fall outside the PUC's expertise of thwarting monopoly abuse.**

**W**ater companies in California face two increasing challenges: meeting stringent federal water quality standards that may require additional treatment devices to be installed and implementing water conservation improvements aimed at stretching water supplies.

The Public Utilities Commission, with its focus on protecting customers by keeping rates as low as possible, makes it difficult for companies to pay for conservation and water quality improvements, putting water suppliers in the middle of competing policy demands and potentially leaving some water customers without safe drinking water.

Water companies also complain that the PUC is too preoccupied with the evolving energy and telecommunications markets to deal effectively with the problems of the water industry, and that PUC filing requirements are too burdensome for small companies.

These issues -- along with the dramatic changes underway in other industries regulated by the PUC -- provides the opportunity to reconsider the State's choices for economic regulation of private water suppliers. That reassessment is essential to ensuring that all of the public's interests are adequately served.

## *The PUC's Regulation of the Water Industry*

The PUC has jurisdiction over California's 195 investor-owned water companies, which together supply 20 percent of the State's domestic water customers. The Commission's oversight of these companies is confined to rate-setting.

Although the three largest companies under the PUC's jurisdiction serve a total of 780,000 customers, most of the companies are small. Only 13 serve more than 10,000 customers and 143 serve fewer than 500 customers each. The PUC has no authority over the State's several hundred municipal water companies, county water districts and special water districts.

The Commission acknowledges that many more small private water companies may be operating in the state, but says that it makes no effort to find them. Said one PUC official:

*The only time we get involved with a company is when it wants to raise its rates or if a customer complains. We don't go out and inspect or go out looking for companies operating without our knowledge. If customers are happy, I'd rather not know about it.*<sup>109</sup>

Ironically, private water suppliers may be the last remaining monopoly utilities of the sort the PUC was set up to regulate. Unaffected by the kind of technological changes that have eroded the natural monopolies in electricity generation and telecommunications, domestic water providers are expected to remain monopolies for the foreseeable future.

The Public Utilities Commission establishes rates for water companies through its standard quasi-judicial proceedings as well as through administrative procedures.

Companies in the Class A category -- the 13 largest -- are required by the PUC to go through a general rate case proceeding to raise rates. Class A companies, which are organized into many water "districts" serving different geographical areas, can apply for a rate increase for each district once every three years. That means a company typically applies for rate increases every year for one-third of its districts. The PUC rules on the rate increase after examining the company's projected revenues, investments, expenditures and reasonable return on equity. At the PUC's urging, some large companies are combining districts to simplify record keeping and rate-making.

All of the 182 remaining companies (Classes B, C and D) are allowed to raise rates through a less formal process. Because these smaller companies have complained that the PUC's procedures impose a difficult burden on their limited resources, the PUC lets these companies raise rates using a simplified administrative process.

Class B companies -- those serving between 2,000 and 10,000 customers -- have the choice of asking for rate increases through a general rate case, a court-like proceeding, or through an administrative advice letter procedure. The smaller Class C and D companies can receive virtually automatic rate increases tied to the Consumer Price Index or can file requests for larger increases. The classifications and the related procedures are summarized in the following table:

<i><b>Water Company Classifications</b></i>			
<b>CLASS</b>	<b>NUMBER OF CUSTOMERS</b>	<b>NUMBER OF COMPANIES IN CLASS</b>	<b>RATE-MAKING PROCESS</b>
Class A	More than 10,000	13	General rate case
Class B	2,000 - 10,000	7	Choice of general rate case or advice letter
Class C	500 - 2,000	32	Choice of automatic rate increase tied to Consumer Price Index or general rate case
Class D	fewer than 500	143	Choice of automatic rate increase tied to Consumer Price Index or general rate case

As the table shows, much of the rate setting for water companies is accomplished administratively. In addition, rate setting for the water industry is far less complicated than for the large and rapidly changing energy and telecommunications industries. As a result, regulating water companies comprises a comparatively small part of the Commission's overall workload. One indicator of the proportion of PUC resources dedicated to water companies is the number of "hearing days" needed to resolve cases. In fiscal year 1994-95, out of a total of 574 hearing days, the Commission devoted 68 hearing days to water -- with 42 of those days spent on rate-making. During the same period the Commission spent 114 hearing days on telecommunications and 288 days on energy cases.<sup>110</sup>

Gauging how much time individual Commissioners spend on water matters is more difficult. One possible measure, however, is the comparative number of ex parte contacts -- private meetings with industry representatives outside hearing rooms. The ex parte records also show that water is a minor part of the Commission's agenda. In the first seven months of 1995, for example, Commissioners held 1,147 ex parte meetings on gas, electricity and telecommunications matters. During that period Commissioners met 13 times with interested parties to discuss water cases.<sup>111</sup>

## *Regulations Affecting Water Companies*

Private water companies, like their public-sector counterparts, are expected to ensure an adequate water supply for future customers and must meet stringent federal standards for drinking water. These standards can require companies to invest in water efficiency devices and programs for conserving water, and to monitor water quality and install treatment equipment where needed to protect human health.

**Water conservation.** The 30 largest investor-owned water systems under PUC authority -- those with 3,000 or more service connections, representing between 10 and 15 percent of the State's urban water use -- are all required by the Urban Water Management Planning Act of 1983 to submit conservation plans to the State Department of Water Resources (DWR).<sup>112</sup>

The purpose of the plans is to encourage water providers to consider conservation measures -- such as low-flow toilets and landscape irrigation timers -- in planning for future water supplies. While companies are not penalized for failing to conserve, companies that do not take measures to save water may be hard-pressed to supply future customers.<sup>113</sup>

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***Reducing demand is one of the State's prime strategies for meeting long-term needs -- and in most cases is the cheapest way for individual companies to supply future customers.***

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With the State's population expected to surge from 33 million to 49 million in the next 25 years and with no new large dams expected, state water planners say California faces a projected annual water supply shortage of between 1 million and 3 million acre-feet of water by 2020 even if all reasonable conservation efforts are made.<sup>114</sup> That gap is enough to furnish between 2 million and 6 million California households with water for one year. Reducing demand is one of the State's prime strategies for meeting long-term needs<sup>115</sup> -- and in most cases is the cheapest way for individual companies to supply future customers.

In recognition of this fact, 150 water interests and agencies in the state, including the PUC and most of the largest water companies under PUC jurisdiction, in 1991 signed a memorandum of understanding on urban water conservation. The agreement spelled out 16 "best management practices," all of which by definition had been found to be cost-effective ways to make efficient use of available water supplies.

The agreement commits the signatories to phase-in the conservation measures through the year 2001.<sup>116</sup> In projecting future water needs, state water planners are counting on annual urban water demand dropping by 1.3 million acre-feet per year by 2020 as a result of water providers following these best management practices.<sup>117</sup>

**Water quality requirements.** All domestic water systems -- including those regulated by the PUC -- must comply with federal Safe Drinking Water Act standards. First passed in 1974, the act was reauthorized in 1986 and again in 1996. The 1986 reauthorization required water system operators to check for many more contaminants and added requirements for treating surface water.

The standards require companies to monitor water quality and to install filtration and disinfection equipment where needed to reduce chemical contaminants and eliminate disease-causing micro-organisms. The expense of upgrading facilities to meet the standards means that many companies must raise rates.

When the act was reauthorized in 1996, Congress lessened the burden of compliance for small companies by including money for grants and loans. But that money may not become available in California until 1998.

In California the federal standards are enforced by the State Department of Health Services (DHS). The department is responsible for overseeing the State's 8,500 water systems, including those under PUC jurisdiction. DHS delegates oversight of the 4,940 smallest systems -- those serving fewer than 200 people -- to county health departments.

For those systems under its direct oversight, DHS conducts inspections, reviews monitoring reports, and issues orders or citations when systems are out of compliance. The Department helps systems correct problems by lining up funding, doing design work, setting up a schedule for work to be completed and tracking progress. The company can continue to supply water while it is out of compliance, but must notify customers that the water may not be safe, leaving customers with the choice of risking health by using the substandard water or turning to bottled water. A citation is issued if the company fails to comply.

In an average year, the Department of Health Services issues some 800 citations and compliance orders to water systems under its direct jurisdiction for failure to meet federal standards.

### *The Milwaukee Crisis*

Federal Safe Drinking Water Act standards are aimed at preventing the kind of contamination that hit Milwaukee in March 1993. That city's water supply was contaminated with an intestinal parasite that left 800,000 people without drinkable water for a week. More than 400,000 became ill and more than 40 people died. Officials believe the parasite came from animal or human feces in Lake Michigan.

Numerous other contamination incidents have affected tens of thousands in New York, Washington, Texas, Oregon, Missouri, Wisconsin and Georgia. In a June 1991 study published in *The American Journal of Public Health*, researchers estimated that "35 percent of the reported gastrointestinal illnesses ... were water-related and preventable."

The federal standards also seek to reduce lead contamination, which is especially harmful to small children. Lead in water can affect a child's developing nervous system, reduce intelligence and cause other serious health problems. According to the *EPA Journal*, in 1993 the U.S. Environmental Protection Agency found that tap water in more than 800 cities exceeded safe lead levels established by the Safe Drinking Water Act.

For the systems under county oversight, DHS provides engineering reports and other technical assistance and furnishes written evaluations of the county health department's work to the board of supervisors. Counties use less formal procedures to bring water systems up to standards, typically inviting company owners in for "office hearings" to work out solutions. As a result, statistics on the number of water systems under county jurisdiction that fail to meet federal standards at any given time are less reliable. These are precisely the small companies most likely to violate standards.

## ***PUC Policies Hamper Water Companies***

The PUC's heavy workload and its overriding interest in keeping down costs to customers create problems for the water companies, their customers and for the State as a whole. These problems are played out in four ways:

**1. PUC rules discourage conservation.** In looking at company expenditures to evaluate proposed rate increases, the PUC adheres to a traditional rate-of-return philosophy that encourages companies to sell as much water as possible. And in looking at proposed expenditures for conservation, the PUC is reluctant to allow companies to recover costs from ratepayers unless the program can be shown to be cost-effective within three years -- even though a 10- to 15-year horizon is needed to realize the benefits of water efficiency investment and to take into account the cost of future water supplies.

As a result, according to the director of the Department of Water Resources, privately owned water utilities are closed off from the water management tools available to publicly owned water suppliers:

*Current CPUC policies and practices inhibit conservation-oriented pricing and investment among investor-owned utilities.... The traditional rate structures, which are the only ones acceptable to the CPUC, do not achieve the efficiencies required to meet the water demands of the next century.<sup>118</sup>*

Ironically, PUC energy rate policies long ago were modified to reflect the diminishing nature of fossil fuels and the economic value of efficiently using resources. Asked why the Commission has not adopted demand-side management for water, the program manager for the PUC's Water Division explained "we haven't had pressure to do that like in energy." The reason, he said, is that "water is not a diminishing resource."<sup>119</sup>

**2. The PUC does not cooperate with state conservation efforts at a policy level.** Even though the PUC signed the urban water management agreement, PUC Commissioners now disagree among themselves about whether that signing means the PUC has agreed to automatically accept the best management practices as cost-effective when applied to individual companies.<sup>120</sup>

The California Water Conservation Council, made up of more than 180 signatories to the urban water conservation agreement -- including 112 public and private water agencies, 17 public interest groups and 43 municipal utility districts, cities, counties, state agencies and other interested parties -- has been working hard since 1991 to implement the best management practices.<sup>121</sup>

Together, the urban water suppliers participating in the Council serve 90 percent of the State's urban population. The Council meets regularly to refine the best management practices and to design a conservation-based rate structure. The PUC is a member of the Council. But according to the Commission's Water Branch Chief, the PUC has limited its participation to sending a staff member to Council meetings as an observer.<sup>122</sup>

The Department of Water Resources -- which is counting on conservation to help satisfy growing water needs -- has tried to get the PUC to actively participate in the California Water Conservation Council meetings and in other conservation

endeavors. It has been largely frustrated in its efforts. In 1992 the PUC set up a water management committee with utility representatives and DWR staff to help utilities begin conservation efforts. But the committee fell apart because the Commission's staff was unwilling to consider a statewide conservation policy or to discuss issues involving specific companies outside of general rate case proceedings.<sup>123</sup> The director of DWR subsequently wrote two letters to the PUC president in 1994 urging cooperation in conservation matters. One of the letters read:

*Being very candid, the department and local water utility staffs throughout urban California seem to have a fundamental difference of viewpoint with the CPUC staff concerning water conservation. It appears to many in the water industry that current CPUC practices inadvertently result in disincentives for water utilities to implement demand management programs.*

*... We have struggled to understand why it has been so difficult to find common ground with the CPUC staff on this issue. Certainly, some of the difficulty comes from the view of the*

### ***Low-Flow Toilets -- An Untapped Resource***

Low-flow toilets are expensive in the near term, but yield big savings by stretching existing water supplies.

According to the Department of Water Resources, a rebate program to replace old toilets with new low-flow technology costs a company \$100 per toilet and the cost of the water saved by the toilets works out to \$300 an acre-foot. By comparison, the Metropolitan Water District of Southern California sells water for \$450 an acre foot. By 1998 state planners project that water will be selling for between \$600 and \$700 an acre foot. Water from a new reservoir would cost \$1,200 an acre-foot, and water from a desalinization plant could cost between \$1,500 and \$1,900 an acre-foot.

Gradually replacing the State's 20 million toilets with low-flow technology is seen as one way to economically meet the State's growing demands. Replacing 60 percent of the State's old toilets over 20 years would save between 400,000 and 800,000 acre-feet of water a year -- more than twice the water that could be supplied by a large reservoir. So far, only about 1.5 million old toilets in the State have been replaced.

*CPUC staff that a very rigorous analysis must be made of any utility investment, including conservation, in order to protect the ratepayer. While this is a laudable goal in an abstract sense, we believe it does not give enough consideration to (the) realities of California's water situation.<sup>124</sup>*

According to DWR officials, the PUC did not respond to either letter.

The PUC maintains that it considers conservation measures in the context of specific rate cases. But water company representatives told the Little Hoover Commission that when they have asked the PUC to approve rate increases for conservation programs they nearly always have been turned down.

In what was widely regarded as a major coup for the industry, Southern California Water Company in 1995 persuaded the PUC to approve cost-recovery to replace a modest 1,000 toilets within its 250,000 customer service area, but such victories are rare. Indeed, when asked to give the best example of its support of conservation programs, the PUC pointed to this one case. A vice president of Southern California Water Company said the company was able to get approval for the low-flow toilets only by partnering with a water district outside PUC jurisdiction to share the cost and by appealing to a PUC Commissioner after the program was first turned down:

*In past years, 1991, 1992, 1993, all water companies got nowhere with the PUC in getting cost recovery for any kind of conservation programs. In 1994 we proposed a partnership program with Metropolitan Water District, where our company would put up 25 cents and MWD and one of its subsidiaries would put up \$1.00. We filed in January of 1994 and it took a year and a half for the PUC to approve it. The [PUC's] administrative law judge denied the program, so we frankly lobbied the assigned Commissioner. We said, "this is really dumb; if you can't approve this, what can you approve? We're getting \$1.00 for every 25 cents we put in." In June of 1995 the Commissioner finally approved it.<sup>125</sup>*

Other companies, he said, had not been so fortunate:

*We're very encouraged, but here's the downside: we're the only company they've allowed to do this. The PUC has implied that the payback period should be low and to do that you may need a partner. But it shouldn't take partnering. In some areas of the state, companies don't have agencies to partner with. Some of the companies just gave up, to be perfectly frank. How many times do you hear "No" before you quit?<sup>126</sup>*

A vice-president of Santa Clarita Water Company, which serves 19,500 customers, confirmed the industry's frustration with the PUC:

*Because of all the problems other people were having, we haven't filed for cost recovery for any conservation programs. The PUC was denying a lot of the programs. People would propose conservation programs based on State Water Plan figures and the PUC would just disregard the figures. We have done things like conservation kits, sent out mailers on how to save water and hired a conservation coordinator, but we just never file for recovery.<sup>127</sup>*

One problem, according to the vice president of Southern California Water Company is that "The PUC doesn't do anything on a policy level. It's all ad hoc."<sup>128</sup>

The PUC maintains, however, that it has done all it should do to advance water conservation. One PUC official said:

*We work hand-in-glove with our sister agencies. But staff won't accept carte blanche what the utility may propose in conservation if it's not cost effective.<sup>129</sup>*

**3. PUC policies are not aligned with water quality goals.** To comply with federal drinking water standards, many water companies must upgrade facilities. It is particularly difficult for small companies to meet the standards. Some 143 of the water companies under PUC jurisdiction serve fewer than 500 customers each. Many of these are businesses operating the water service as a tangent to other activities or to supply a housing development far from existing municipal services.

These small companies are typically underfinanced, unable to pay for system upgrades and leery of participating in the PUC's complex proceedings to obtain rate increases. As a result, these companies -- particularly those in remote rural area -- account for many of the water systems that fail to comply with drinking water standards.

Of the 900 small surface water systems in the state under direct DHS jurisdiction -- all of them serving fewer than 1,000 customers -- some 150, or 16 percent, are out of compliance with safe drinking water standards at any given time. Often systems go in and out of compliance because deteriorating infrastructures lead to breaks in mains and subsequent contamination or because the company lacks the staff or the management inclination to monitor water quality.<sup>130</sup>

Rectifying problems by disinfecting water or investing in filtration equipment and passing costs on to ratepayers is much more difficult for

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***Of the 900 small surface water systems in the state under direct DHS jurisdiction -- all of them serving fewer than 1,000 customers -- some 150, or 16 percent, are out of compliance with safe drinking water standards at any given time.***

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small systems than for large systems. The PUC allows companies to recover all "reasonable" expenses through rate increases and the Commission says it considers expenses necessary to comply with water quality mandates to automatically satisfy the "reasonable" test. That works fine for large companies that can afford to pay for needed improvements up front and recover costs up to a year later through a rate increase. But small companies often lack the money to invest in advance, and have a smaller customer base to absorb the cost over time.

Meeting the standards also has a much greater impact on rates for small companies than it does for large companies. While large companies typically need to increase rates only about 5 percent to comply with the federal standards, companies serving fewer than 1,000 customers may have to raise rates as much as 100 to 200 percent.<sup>131</sup> As a result -- while the expense of complying with the federal standards costs the average household nationwide only \$12 a year -- the average cost for customers of small companies comes to \$145 a year.<sup>132</sup>

The PUC has tried to address the problems of underfinanced companies by making it easier for companies with fewer than 10,000 service connections to file for rate increases to recover costs. But those procedures do not help companies that lack the funds to pay for upgrades in the first place. Nor do they solve the problem of companies that lack the management or the resources to properly monitor water quality.

Whether the improvements are funded with loans or through higher rates charged to water customers, resolving impediments to making upgrades requires the PUC and DHS to work together at a policy level. Recognizing the need for cooperation in water quality matters, the PUC in 1987 signed another memorandum of understanding -- this one with the Department of Health Services. That agreement spells out the intent of the two agencies to keep one another informed of actions involving water companies under their common jurisdiction and to meet at least semi-annually to review water quality efforts and resolve problems. But the two agencies have not met since the agreement was signed, and when the agreement was updated in 1996, the meeting requirement was dropped.<sup>133</sup>

#### ***4. PUC does not devote adequate resources to water oversight.***

The private water companies complain that with all its other responsibilities, and with only 27 staff people to oversee more than 200 companies, the PUC does not give the water industry enough attention. The most recent accounting found that the PUC is collecting \$8.3 million in fees each year from the private water companies under its authority, but spending only \$6 million to regulate the industry.<sup>134</sup>

The PUC's disinterest in locating water companies operating without its knowledge isolates these companies even more than others from possible financing mechanisms and leaves customers without a ready forum for resolving disputes.

The water companies say they want to remain under the purview of the PUC, preferring to “stay with the devil you know.” But they have urged the PUC to speed up the rate-making process and to have at least one Commissioner present in contested proceedings.

They also want the PUC to set up a water policy board made up of health and water and PUC officials to ensure Commission decisions are consistent with the policies of the other regulating agencies. The PUC has had a water policy board in the past -- but the board has been made up solely of the PUC’s own water and ratepayer advocacy staff.

## *What’s Needed*

To ensure that customers of private water systems are provided with safe and adequate water supplies, water companies need two ingredients: competent management and enough funds to keep infrastructure sound and to make any needed investments in treatment and conservation.

In the past DHS has been able to help small water companies upgrade systems with loans from a state revolving fund. The fund provided \$425 million over 15 years and funded 533 such projects between 1976 and 1991. But the program ended when the last state bond measure authorizing water quality upgrade funds failed in 1992.<sup>135</sup>

Some companies have tried turning to the private sector to finance system improvements. But PUC policies stand in the way. Water industry representatives told the Little Hoover Commission that the PUC’s rigid rate-of-return policies and after-the-fact review of allowable expenses makes small companies unattractive to lenders. The director of the California Water Association, which represents investor-owned water companies, explained:

*A lender looks at how stable a company is to see whether it can repay the loan. If the earnings are all over the place ... a lender won’t look at them. The Commission allows a certain level of expenses, but if something comes up like having to do another set of testing for the Department of Health Services, it can double their expense budget in one year. A more consistent treatment of rate of return would allow lenders to have a little more confidence in the small companies.<sup>136</sup>*

With state and private loans out of reach, many companies simply remain out of compliance. PUC officials and industry representatives said some small water companies -- when faced with large bills, regulatory hurdles and violation notices -- abandon the system, and the customers, altogether.

## ***Two Potential Remedies***

California has two possible remedies to the problems of small, under-financed water companies: federal funds provided by Congress when it reauthorized the Safe Drinking Water Act in 1996, and the possibility of consolidating small water companies with larger, more financially sound systems.

***Federal funds.*** The 1996 amendments to the federal Safe Drinking Water Act provided funds to help improve systems that lack the resources to meet safe drinking water standards. Altogether California is expected to receive \$60 million over each of the next five years to improve the state's water systems.

The amendments established a revolving fund to give companies grants and low-interest loans to fund upgrades and bring contaminants to within specified levels. As the loans are repaid, the money will be loaned again to other water suppliers -- a strategy the State effectively used in the 1970s and 1980s to finance construction of sewage treatment works.

The amendments also require states to provide more technical assistance to small water systems, work to eliminate hazards to groundwater, assess the workability of new water systems and encourage consolidation of small water systems.

In addition the amendments increased the grant money states get to enforce federal Safe Drinking Water Act requirements. California's grant share for that purpose will increase from \$4.8 million to \$5.6 million. The enforcement money will go to the Department of Health Services, which was the agency designated by the U.S. Environmental Protection Agency in 1977 to carry out the State's federal Safe Drinking Water Act responsibilities.<sup>137</sup>

It has not been determined which state agency would manage the revolving fund. The State Water Resources Control Board has administered the revolving loan program for sewage treatment plant improvements. But the Department of Health Services administered the State's former revolving fund for upgrading water systems.

Two hurdles must be cleared before the federal grant and loan money is available. First, Congress must take additional procedural steps to free the money from sewage treatment accounts. And perhaps the higher hurdle, California will have to provide 20 percent matching funds. Health officials say the Governor and the Legislature probably will have to consider a bond measure -- and likely have to go to voters for approval -- to generate the state match.

***Consolidation.*** Another possible answer is to facilitate the sale of small water systems to larger companies or local governments. An industry-wide trend toward consolidation of small companies is already underway.

According to the PUC, the number of small companies in California has shrunk 25 percent in the past five years, from 243 to 182 as small companies are absorbed by other companies and districts, partly as a result of the increased costs arising from federal water quality standards.

With cooperation from government, many more small companies could be consolidated or folded into larger companies, according to industry officials. But those officials say PUC policies create a barrier by restricting the purchasing company's return on the investment and making it difficult for large companies to purchase companies that show inconsistent earnings. The California Water Association testified:

*Right now, if we were to buy a small company, the Commission would allow us to earn strictly on what they determine to be the rate base of that company regardless of what it may be worth on the open market or not worth on the open market.<sup>138</sup>*

The California Water Association has asked the PUC to provide incentives for large companies to purchase smaller, financially ailing systems. In other states, such as New York, utility regulators have provided financial incentives by granting the large companies a slightly higher rate of return if they take over troubled water systems.

The PUC is considering these and other policies to encourage consolidation, but has not given the issue priority or initiated an investigation into changing its rate-of-return policies. Partly as a result, in the past year only four water companies in the State have consolidated.

The 1996 federal Safe Drinking Water Act amendments provide mechanisms to help make it economically feasible for large companies to take on the physical or managerial control of smaller systems. In the meantime, with few resources to help companies meet water quality standards, DHS is allowing water systems to remain out of compliance with the hope that federal money will be freed up in 1998.

Whatever the outcome with the federal funds, it is clear that the Commission's policies by themselves do not achieve the overriding policy goals -- to quickly and efficiently bring about the improvements needed to ensure that customers of small water companies have adequate amounts of water and that the water meets safe drinking water standards.

## ***Changing Regulatory Options***

**O**n a broader scale, the challenges of both large and small water companies in meeting federal water quality standards and undertaking conservation measures should be addressed by a government entity equipped with the resources, capabilities and culture necessary to effectively meet that need. With water quality and water

efficiency regulations driving rate issues, the economic regulation of private water companies will be better conducted by an agency with both a broad-based understanding of water issues and the technical skills to conduct rate proceedings.

The State of Texas -- which is confronting similar policy issues and which has a market profile nearly identical to California's -- has taken precisely that action, moving rate regulation of private water companies to a water resources board with duties similar to those of the California State Water Resources Control Board. The Texas water board was subsequently merged with other resource-related boards into a large environmental resources commission, The Texas Natural Resources Conservation Commission.<sup>139</sup> As a result, most rate cases are settled administratively, with the health and rate regulators working together in the same office.

In California, the State has more options for assigning regulatory authority for private water companies than it did when the PUC's predecessor took on the function at the dawn of the century. Even if policy makers had been concerned about water quality and dwindling water supplies at that time, no other appropriate agency then existed to address those issues.

In 1969, recognizing that need to coordinate water quality and water supply oversight, the Legislature enacted the Porter-Cologne Water Quality Control Act. The Act gave primary responsibility for balancing beneficial uses of water and controlling water quality to the State Water Resources Control Board, assisted by nine regional boards. The State Water Resources Control Board consists of five full-time salaried members, each with a designated specialty, who are appointed to four-year terms by the Governor and confirmed by the Senate.

The Board has broad authority to allocate rights to the use of surface water, to prevent the waste or unreasonable use of water and to protect the State's water quality. Where the Department of Health Services protects water quality at the tap, the State Board guards water quality at the source -- groundwater aquifers, lakes and rivers. It issues permits for the diversion of water from streams and rivers, taking into account water availability and other beneficial uses. Through the regional boards it develops water quality plans and issues and enforces waste discharge permits, specifying conditions required to protect water quality.

The Board exercises its authority through both quasi-judicial and quasi-legislative proceedings and is subject to general open meeting law requirements. Members also operate under strict conflict of interest and ex parte meeting rules.

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***Now more than ever before, the issues of water quality and water supply are linked... Needed in addressing these concerns is a comprehensive understanding of the State's water system and a close working together on the part of all the agencies involved.***

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Now more than ever before, the issues of water quality and water supply are linked. Strict water quality standards to protect human health, wetlands, endangered species and the environment at large draw from the water supplies available to farms and cities. Disinfection byproducts resulting from new, more rigorous disinfection requirements for drinking water can add to water quality problems downstream. Needed in addressing these concerns is a comprehensive understanding of the State's water system and a close working relationship on the part of all the agencies involved. Some experts say that effective leadership and only modest changes in the state's water use could completely close the gap between projected state water demand and supplies by 2020.

With responsibility for both water quality and water supply, the State Water Resources Control Board has the statutory framework and organizational culture to regulate water companies in a way that takes into account all policy imperatives. The board's oversight of industrial facilities discharging wastewater, with the need to evaluate the financial integrity of waste discharge permit holders, involves functions similar to the PUC's oversight of private companies providing water to customers.

The Secretary of the California Resources Agency believes serious consideration should be given to transferring the water-related rate-setting functions from the PUC to the State Water Resources Control board.

*....Streamlining procedures within the current regulatory framework, case-by-case negotiated rate settlements and creation of policy oversight committees may improve coordination of the various regulatory purposes at best and add another layer of government bureaucracy at worst. Unfortunately, we fear such band-aids may do very little to ensure that innovations in conservation of water or improvements in water treatment technology to meet health standards will be encouraged or rewarded.*

*....The Little Hoover Commission has the potential to craft a solution that would achieve two important goals: to improve the quality of state programs and services while containing the costs of delivering them and to improve the delivery of economically stable, safe, healthy and environmentally sound water to California's consumers.<sup>140</sup>*

## ***Recommendations***

***Recommendation 11-A: The Governor and the Legislature should enact legislation transferring the economic regulation of the private water suppliers from the PUC to the State Water Resources Control Board.***

The State has more choices today for assigning the economic regulation of private water companies than it did at the dawn of the century when utilities shared the commonality of monopoly status. The State Water Resources Control Board has the procedural experience and the water expertise needed to address the primary concern facing California's water suppliers and their customers -- a safe and adequate supply over the long term.

***Recommendation 11-B: The State Water Resources Control Board should investigate and implement incentives for consolidating small water companies and for financing water quality and efficiency improvements to water systems.***

The State Water Board is the agency best suited to bring about these changes, but the opportunity provided by federal loans and the willingness of some larger systems to take over small, under-financed companies should be pursued by whatever agency has responsibility for regulating the private water industry. The State Board should work to facilitate the funding of water quality and conservation improvements for small companies and should coordinate with the Legislature and counties to encourage the sale of these companies to responsible entities.

# Consumer Protection

- ❖ *In monopoly and other economically regulated markets, the PUC was considered a one-stop shop for consumer protection -- guarding against price abuse, implementing social policies and resolving ratepayer complaints.*
- ❖ *As more utility services are provided by competitive markets the PUC will be unable to protect consumer interests in the variety of legislative, administrative and judicial arenas where they will be defined.*
- ❖ *In competitive utility markets, the State will need to ensure that consumer interests are expertly represented in the various venues where those interests are at stake.*



# Consumer Protection

**Finding 12: In competitive markets, as public decisions may be diffused, residential and small business customers may not be well-represented in a number of regulatory, legislative, administrative and judicial venues.**

**S**tripped to its core, the original purpose of the PUC was to protect consumers in the absence of a functioning market. The State's new strategy is to facilitate the market wherever possible -- policing those industries as it does others for antitrust behavior and consumer fraud. Where remnant monopolies remain, regulations should be maintained.

The transition from monopoly to market has sparked considerable debate about how to best protect consumers. A significant portion of the debate has focused on how consumers are represented in policy venues -- and in particular the role of ratepayer advocacy at the PUC and whether that function should be placed outside the Commission or whether it should continue at all.

Another aspect of consumer protection comes in the form of government actions. As competitive utility markets develop, the PUC intends to transform itself from regulator to marketplace guardian.

That strategy has raised questions of whether the Commission has the jurisdictional authority, the cultural understanding and the expertise to meet the new challenges. That decision also neglects the role already performed by other state agencies, most notably the Attorney General.

## *The PUC as Consumer Guardian*

The Public Utilities Commission divides its consumer protection duties into three categories -- customer services, to help customers resolve complaints against regulated utilities; public advising, to help members of the public who want to intervene in Commission proceedings; and ratepayer advocacy, to argue the interests of ratepayers in Commission proceedings.

Of the three functions, ratepayer advocacy has been the most controversial. Created in the mid-1980s at the behest of the Legislature, the PUC's Office of Ratepayer Advocates -- known until 1996 as the Division of Ratepayer Advocates -- has a national reputation for its ability to scrutinize utility expenditures and ferret out billions of dollars in costs that the Commission ultimately found should not be paid by utility business and residential customers: \$6 billion in the Diablo Canyon settlement and \$1 billion in the San Onofre settlement. The Division's work also led to a \$250 million penalty against Southern California Edison for overpaying independent energy producers belonging to Edison subsidiaries.<sup>141</sup>

The assertiveness of the PUC's ratepayer advocacy unit has generated criticism from some of the regulated utilities -- who believe the advocates were too antagonistic toward the companies and carried that antagonism with them as they were promoted to key management and advisory positions. The Commissioners responded to those complaints in their Vision 2000 reorganization plan by proposing to abolish the advocacy unit and dispersing that function into the PUC's new industry-based divisions.

The proposal was controversial among consumer groups, who feared the unit's critical voice would be lost. It was similarly controversial among regulated industries, which were concerned that the Commission's staff analyses would become tainted with consumer advocacy.

The debate yielded considerable support for creating an independent consumer advocate -- perhaps in the Attorney General's Office. While some consumer groups preferred to keep the advocacy staff within the PUC, they were afraid that Commissioners would limit its resources and role in Commission proceedings. The Utility Consumers' Action Network (UCAN) described the concern: "This is a division that once worked well and no longer does. It is understaffed, overworked, depleted of talent and devoid of leadership."<sup>142</sup> The utilities, meanwhile supported the idea of shifting the function outside the PUC to clearly delineate advocacy before the Commission from advisory to the PUC.

The Legislature responded to the debate in its 1996 Commission reform measure. SB 960 (Leonard) re-established the advocacy function within the PUC as a separate division, with a budget to be separately determined by the Legislature and with a director appointed by the

Governor and confirmed by the Senate.

Consumer protection has a second facet beyond advocating the consumer cause in proceedings: to actively resolving consumer-related issues. The PUC, to a large degree, has done both over the decades that utility services have been provided by monopolies. While its advisory and advocacy units provided information, the Commissioners used their authority to set and enforce regulations intended to balance the economic needs of captive customers and sole producers.

As competitors have entered the markets, the PUC has expanded that role to police unfair business practices. The Commission, for example, has aided thousands of customers who have been victimized by "slamming" -- tricked into changing long-distance telephone service -- and subjected to other aggressive marketing ploys. Similar tactics can be expected as competition gets underway in the electricity market.

The impact is reflected in the statistics recounted in the PUC's annual reports. In 1993-94, the Commission responded to 48,340 complaints and required \$531,072 to be refunded to customers. In 1994-95, it responded to 60,127 complaints and refunded \$2.1 million. Most of that increase can be attributed to the telecommunications industry.

The Commission believes it has responded swiftly and assertively to close the door on abuses. But consumer representatives, such as UCAN, are concerned that the PUC lacks the resources to respond to complaints and enforce rules while at the same time setting policies and scrutinizing the crush of applications to provide service. The PUC in 1996 had 10 employees to respond to consumer complaints -- down from 19 people in 1992, according to UCAN. The consumer group said the Department of Insurance's Consumer Complaint Bureau has 43 people answering telephones. During 1995, UCAN said, the PUC installed an automated telephone answer system that "precludes all but the most ingenious customers from talking to a real person."<sup>143</sup>

The Legislature, in addition to reconstituting a ratepayer advocacy unit, affirmed that at least in the near term the Commission will have a significant role in consumer protection. It provided for the PUC to register new entrants into energy markets and established procedures to prevent overaggressive marketers from switching a consumer's electricity service without consent. But the Legislature recognized that aggrieved consumers also have the ability to file civil actions directly against the offending company.

The debate over how to best provide consumer advocacy and protection did not begin with the emergence of competitive energy market. And the experience of other states is helpful in rethinking California's long-term strategy for meeting these needs.

## *The Model of Other States*

California is not unique in having established a voice for ratepayers. Virtually every state has a utility consumer advocate to represent that class of ratepayers who combined have a huge interest in the outcome of proceedings, but individually have such a small interest that it is not worth their time to participate.

But California stands almost alone in housing the ratepayer advocate within the Public Utilities Commission. In 47 other states, advocates for utility customers are outside of the agency regulating utilities. In 17 of those states, the advocate is part of the State Attorney General's office; in 16 states the advocate is a separate government entity and the rest are situated in a consumer affairs office or a related agency. The California Research Bureau reports that in states having this structure various administrative arrangements are made to prevent conflicts of interest among the attorney general's clients.

The separate agencies are routinely funded by the same fee that public utility commissions use to fund their activities. Many of the offices rely on a multi-disciplinary team of analysts, economists and attorneys to review proposed policies, regulations and utility applications and determine the consequences those actions will have on consumers. Records from the National Association of State Utility Consumer Advocates (NASUCA) show that of 44 states with separate consumer advocates, 39 employed attorneys, 19 employed economists, 18 employed financial analysts and 17 employed rate analysts.

The PUC's ratepayer advocates unit, incidently, has not been able to join NASUCA, which provides a monthly exchange on the problems experienced in other states and the solutions being employed. The association requires members to be separate from the regulatory commission. California consumers are represented in this forum instead by California-based nonprofit organizations.

Maintaining an advocacy unit inside the Commission provides the staff with the opportunity to be privy to information developed by the advisory staff and enhances the ability of advocates to build a relationship with Commissioners. But the advocates also suffer from limits on how aggressively they can pursue particular positions and have no standing to represent consumers outside the Commission.

The PUC's ratepayer advocates had no voice, for example, in the legislative hearings on the Commission's plan to restructure the electricity industry -- even though that plan determined how billions of dollars in utility expenses would be passed on to the public. The advocates similarly had no voice when the Legislature took on reform of the Commission itself. In both of those instances, the interests of California's 33 million consumers -- virtually all of whom will be affected by those events -- were represented by nonprofit organizations that were

outnumbered and out-financed by the market players.

The benefit of a utility consumer voice outside the regulating commission was demonstrated in the Pennsylvania case, *Duquesne Light Co. vs. Barasch*. In *Duquesne*, the U.S. Supreme Court found that excluding the costs of a canceled plant from the utility's rate base did not constitute a taking by the regulatory commission even though the commission had originally approved the plant and found the costs reasonable. The case, brought by Pennsylvania's independent consumer advocate, effectively struck down the unwritten regulatory compact between the commission and the utility that committed ratepayers to paying 100 percent of the costs incurred by a utility -- whether that investment was lost because of bad management or "stranded" by the advent of competition. The case challenged the assumption of that state's public utilities commission -- and the assumption of other commissions across the country -- that utilities were entitled to recover all costs regardless of the reason for the expense.

Such a case could not have been brought in California in recent years, because here the consumer advocate has had no authority to act outside Commission proceedings.

In the rapidly unfolding telecommunications and electricity markets, these limitations will become an increasing impediment to representing consumer interests wherever and however they need representation.

## ***Consumer Needs in Competitive Markets***

Consumer protection in a monopoly market requires scrutinizing utility expenses and decisions to make sure that ratepayers are getting a good deal. But in a competitive market, government intervention often results in higher, not lower prices. Consumer protection is just as important -- but rather than focusing on the quality of service or the price, the concern is whether companies are engaging in consumer fraud or antitrust behavior.

The desired outcomes also are different: In a monopolistic market, where companies receive a franchise for exclusive service in exchange for regulation, the public has an interest in the company's long-term health. But in an open market, the public benefits from suppliers competing to offer the best services at the lowest prices -- regardless of the effect on existing companies.

The debate over consumer protection has revealed that Californians will need government to play both roles for some time: Where competition is emerging, the government can best protect consumers by policing the market to prevent fraud or market abuse. Where remnant monopolies remain, so must monopoly regulation.

During the transition, consumer advocates maintain that extra diligence

will be required to ensure that incumbent companies segregate their monopoly services from their market-based enterprises. A former director of the PUC's Division of Ratepayer Advocacy warned: "Utilities have and still strive mightily to transfer costs from competitive services to captive customers."<sup>144</sup>

In competitive markets, consumer protection will begin with solid information that allows consumers to make wise decisions and avoid problems. When problems occur, consumers will need a place to take their complaints. These functions do not naturally follow the Commission's expertise of economic regulation. A former PUC division chief testified:

*Protecting consumers from fraud and abuse in a competitive market matches neither the PUC's core business nor its core competency. Increasingly faced with the sort of consumer protection issues common to competitive markets, but unfamiliar to an agency grounded in traditional monopoly regulation, the PUC finds itself forced to resort to ad hoc measures, cobbling together resources and engaging in regulatory triage.<sup>145</sup>*

Similarly, the Center for Public Interest Law at the University of San Diego warned that Californians should expect to see an a "panoply of abuse" by competitors engaging in price discrimination, price fixing and predatory practices. And try as the PUC might, the Center was unconvinced the Commission could adequately respond to the new challenges.

*The PUC has little record as an effective detector or prosecutor of competitive sector antitrust violations. It has a good record in detecting sales deceptions, service failures and related monopoly power abuses. But the two are very different kinds of offenses.<sup>146</sup>*

As competition in the telecommunications industry unfolds, with new technologies, new services, billions of dollars at stake and hundreds of new market players -- most of them not under the PUC's regulatory authority -- the needs of consumers will be rapidly spinning beyond the Commission's expertise and its jurisdictional reach.

A diversity of actions in a variety of venues will need be taken -- to counter unfair marketing practices by seeking administrative or judicial remedies, to recognize potential market power abuses and initiate antitrust actions; to keep abreast of new technologies; to keep the Legislature informed about needed policy changes, and to educate consumers about market developments and potential fraud so they can make informed purchasing decisions.

Many of these functions are already being carried out by the Attorney General in a number of arenas.

California's Attorney General has broad authority to protect the public interest in antitrust and market power issues and to act against companies that engage in unfair business practices and collect civil penalties.<sup>147</sup>

The Senior Assistant Attorney General for Consumer Law testified: "The Attorney General's office has a long history of cooperating with other agencies to solve consumer problems." It works with county district attorneys, city attorneys and the attorneys general in other states. It works with state agencies -- including the PUC and the Department of Consumer Affairs -- to collect information and take action through the appropriate venue.<sup>148</sup>

The Attorney General's Consumer Law Section already has been involved in utility-related disputes. It has filed actions against cellular phone sellers, inter-exchange carriers, aggregators, resellers and other telecommunications companies for a range of unfair and unlawful practices including slamming, false billing, fraud and unfair collections methods. Similarly, the Attorney General's Antitrust Section already has investigated independent power producers and has advised the PUC on the laws governing the marketplace. It has assessed proposed utility company mergers for their potential effects on competition. The Senior Assistant Attorney General for the Antitrust section said the role of the Attorney General naturally expands as market forces replace monopolies:

*An important goal of regulation is to cause the utility to act as if it were constrained by competitive forces. In contrast the goal of antitrust is to induce competitive behavior in markets where such behavior is feasible.*<sup>149</sup>

But this broad experience and reach also has a critical shortcoming. The Attorney General's existing consumer-related staff is comprised largely of generalists, juggling competing priorities to police the actions of various industries.

The utility consumer advocate for Nevada -- one of 17 states where that function is housed in the Attorney General's office -- said that as the markets transition, the advocacy staff will work more closely with the Attorney General's market-oriented enforcement units, providing them with the expertise to watch for potential market power abuses.

Similarly, California's consumer advocates -- and the State's larger role in consumer protection -- will need to be effective in both monopoly and competitive arenas. The success of the State's policy to give the market the chance to work will depend in part on effectively gauging when and where consumer interests are best protected. An environmental and renewable energy advocate described the balance this way:

*Market power is a terrible thing to waste. And if you fail to remove it in the beginning, you will need to intervene. You may not want to micro-manage the market, but you have to make the*

*market responsive to public and environmental considerations.... Where customers are hurt is where they don't have a choice and some customers won't get it in electricity for a long time. The more competition, the less regulation. But saying you have competition isn't the same thing as having it.<sup>150</sup>*

The California Attorney General has maintained that regulatory advocacy should remain at the Public Utilities Commission, with the Attorney General's office fulfilling a complementary role. The Legislature followed that model in its SB 960 reform legislation, by reconstituting advocacy within the PUC.

But the ability of the PUC's advocacy unit will increasingly shrink while the Attorney General's complementary role already is growing. This transition will be smoother if the resources and expertise that once were dedicated within the PUC were gradually shifted to the Attorney General.

## ***Recommendations***

***Recommendation 12: The Governor and the Legislature should create within the Attorney General's Consumer Law Section an office of utility consumer protection. The office should represent consumer interests in legislative, administrative and judicial proceedings.***

The Attorney General already has the standing to fill this role, but in the past has relied more on the full-service regulatory strategy of the PUC to protect utility consumers. And as the monopolies give way to the market, the Attorney General's role would naturally increase in this arena. To encourage cooperation, prevent duplication, and provide effective consumer protection, resources and expertise should be shifted over time to enable the Consumer Law Section to better fill this role. The legislation should specify that the unit will employ a combination of attorneys, engineers, economists and policy analysts and will be funded by reallocating a portion of the existing user fees assessed to fund the Public Utilities Commission and the California Energy Commission.

# Process & Management

- ❖ *Potential competitors and consumer interests are concerned about PUC Commissioners making “policy” decisions based on closed-door discussions with investor-owned utilities, particularly since those decisions cannot be reviewed by a court to determine if they were based on the factual record.*
- ❖ *The significant organizational changes facing the PUC require that a partnership be established between labor and management that could best be nurtured if the PUC were relieved of some civil service regulations.*



# Procedural Accountability

**Finding 13: The PUC's procedures, even as amended by the Legislature in 1996, provide the least accountability to the public and the fewest assurances that decisions will be based on the factual record in precisely those cases where the greatest profits and the greatest public interests are at stake.**

**A**s the PUC participates in the development of competitive utility markets and its jurisdiction is curtailed to focus solely on telecommunications, the credibility of its decision-making procedures will be critical. The PUC envisions itself taking on a larger policy making role in the future. That will require spending less time in the judge-and-jury role of a full-time regulator and more time defining the rules that market players and consumers will live by and redefining the public interest.

This distinction -- between the PUC's quasi-judicial and quasi-legislative roles was the source of significant debate during the recent legislative reform efforts because it goes to the long-standing controversies about how the PUC makes decisions, the roles of individual Commissioners themselves and the finality of those decisions.

Commissioners assert that policy making is legislative in nature, and when acting as legislators they should be given freedom to meet privately with stakeholders and among themselves. The Commissioners also asserted that they should retain freedom from expanded judicial review, effectively making their decisions final.

Freedom, however, cannot be expanded incommensurately with accountability, or granted in a way that erodes confidence in public decision making. The process the Commission uses to make policy decisions needs further refinements to bring these values into balance.

## *A Policy of Process*

While complex in the detail, the PUC's procedures are simple in their intent. The PUC establishes rules for how it will function and then uses those rules to process hundreds of individual cases a year. Through hearings and written filings, the PUC gathers evidence, ideas and feedback from parties and the public. With the assistance of analytical staff and hearing officers known as Administrative Law Judges (ALJs), Commissioners craft proposed decisions and consider public comments on those proposals. After ruling, the Commissioners weigh any requests for reconsideration before making the decision final.

Of greatest concern in recent years has been the role of the individual Commissioners. With more than 900 active cases at any one time and more than 600 hearing days calendared each year, Commissioners rely extensively on their staff to develop and analyze the record and craft proposed decisions.

In addition to the case work, the Commissioners spend considerable amounts of time attending national and international conferences and meeting with other public officials in the State, the region and in Washington, D.C. Without judging the value of those trips, any effort to make Commissioners more involved in individual cases must consider the role Commissioners have taken in representing the State in other venues.

The dynamics of this controversy are framed by two factors that have significant impacts on the decision-making process -- the ability to lobby Commissioners in private meetings before a decision is made, and the right to seek a court review of those decisions after the fact.

***Private Meetings.*** As a result of the heavy caseload -- and their other duties -- Commissioners concede that they are unable to sit through many of the hearings in which facts are gathered for their consideration. Similarly, they do not have the time to read all of the written submittals. The decisions themselves often run in the dozens of pages, making that task alone burdensome given the hundreds of cases before the Commission.

To compensate, Commissioners have relied on private and individual meetings with participants in the proceedings, known as "*ex parte*" contacts. During these meetings the issues are "telescoped" and Commissioners have the opportunity to ask questions directly that might be indirectly addressed in hundreds of pages of testimony. A review of the Commissioners' calendars show that some Commissioners spend a considerable amount of time in private discussions -- usually at the request of the party rather than the Commissioner.

The Commissioners have been free to set their own *ex parte* rules -- and for years they had no *ex parte* restrictions of any kind. After

considerable controversy in the late 1980s, the Commission developed rules that required contacts to be “noticed” after the fact and a summary provided by the party making the contact, along with any written materials used in the discussion.

It is up to other parties to monitor the *ex parte* log if they are concerned about what another is saying in the private meetings. The rules covered rate cases and adjudicatory issues. Notification was not required for meetings to discuss rule-making or policy-making cases before the Commission, or for social engagements.

Commissioners have been criticized by consumer groups, small businesses and its own advocacy staff for the heavy reliance on *ex parte* contacts. The concern is that Commissioners are persuaded to alter proposed decisions based on those private conversations -- potentially making decisions inconsistent with the factual record or without benefit of having heard the rest of the arguments. The consumer group Toward Utility Rate Normalization (TURN) testified:

*Such last-minute changes to proposed decisions nearly always shift the outcome in a manner more favorable to the regulated entity, and less favorable to consumer and competitor interests. To say that such a process breeds cynicism toward government would be an understatement.*<sup>151</sup>

The owner of Zond Energy Systems, an independent wind power producer, said the lobbying rules are biased in favor of investor-owned utilities and against small companies:

*Probably the most frustrating aspect of working at the CPUC is participating in the time-consuming and expensive process of a litigated proceeding before an administrative law judge, receiving a decision you believe is favorable then having that decision changed materially to your detriment by an assigned commissioner’s ruling.*

*The failure of the Commission to issue a decision based upon the evidence or hearing record is a gross abuse of process. This failure of process occurs because that Commissioner has been effectively lobbied by the (investor-owned utility) lobbyist who maintains offices next door to the PUC and expends ratepayer funds in support of those efforts.*<sup>152</sup>

The concern is heightened by the fact that the vast majority of private meetings are conducted with representatives of regulated utilities. A review of *ex parte* records for a 16-month period in 1995 and 1996 showed that for every private discussion held with a consumer interest, Commissioners met four times with a utility representative.

A review of Commission calendars also showed that some Commissioners have social, casual and other contacts with the same

utility officials. But those meetings are not reported as *ex parte* contacts -- presumably because the conversation did not involve a specific issue before the Commission or it involved a "policy-making" case, which does not have to be noticed.

While consumer groups have long been troubled by the social contacts, it also is a concern of new market players who do not have the benefit of years long relationships with Commissioners. Representatives of the cable television industry -- which has not been regulated by the PUC, but will be as they offer telecommunications services -- believe that social contacts should be noticed: "The contact is influence in itself."<sup>153</sup>

For the most part, the large utilities do not favor tight *ex parte* rules, particularly for quasi-legislative or policy making cases. The Commission's proceedings to restructure the electrical industry is an example of such a proceeding: The Commission held workshops and hearings and private meetings before crafting and adopting a policy.

While such policies are more general than a specific rate increase application, they can significantly influence how much consumers pay. In the case of the electrical restructuring policy, the Commission decision provided the utilities an opportunity to be repaid by ratepayers for billions of dollars worth of investments that were made in a regulated era that will be worthless in a competitive market.

The utilities, however, are more open to the idea of increasing judicial review -- giving them greater opportunity to appeal Commission decisions that are less to their liking.

***Judicial Review.*** Some practitioners maintain there is a relationship between the latitude that Commissioners are given in the decision-making process and an independent review of those decisions by the courts. If the PUC faced more meaningful judicial review to determine if decisions are supported by the facts, then Commissioners should have latitude in how they collect information and balance competing interests.

Under the current arrangement, Commissioners are lobbied by parties before making decisions and decisions cannot be appealed to determine if they were made based on the evidence. Rather, cases can only be reviewed to determine if constitutional rights were violated and they can be reviewed only by the California Supreme Court.

Other fourth branch agencies -- in California, other states and at the federal level -- often have elevated thresholds for judicial review, usually to a court of appeal. The commissions are granted that elevated threshold on the theory that their own quasi-judicial proceedings are the functional equivalent of a trial court, and the public is willing to trade some of the normal checks and balances of the three-branch system of government for the efficient decision making provided by fourth-branch agencies.

All states except California, New Mexico and West Virginia provide for appeal of all PUC decisions to an intermediate court -- and New Mexico and West Virginia both provide more opportunities for appeals to be heard than does California. As a result, California has had the highest threshold in the nation for judicial review of PUC decisions. Appeals could only be made to the State Supreme Court. The court is free to review only cases it wants to and it only reviews cases to determine if the Commission violated the law.

This threshold was lowered slightly by SB 1322 (Calderon) enacted in 1996, which allows for appellate court review of the PUC's adjudicatory cases and allows for the appellate court to review those decisions to determine if they are supported by the evidence.

The State Supreme Court has historically turned down 90 percent of appeals without any review. In the last 10 years, the Supreme Court has issued 10 decisions on appeals made from the PUC. That is 10 out of more than 7,000 decisions that the Commission made during that period. The PUC cites those facts to assert that judicial review exists; critics cite the numbers to show how few cases receive judicial review.

Ironically, the decisions of federal energy and telecommunications agencies are subject to federal appellate review and the PUC has frequently exercised that opportunity to challenge rulings by those agencies.

## *What the Legislature Started*

The Legislature has tried to reconcile these issues by turning to the legislative decision-making model: Elected officials are given great freedom in how they make decisions. Those decisions can be challenged in Superior Court, but usually the only test is whether a statute violates the Constitution. The Legislature also looked at the judicial decision-making model: Appointed jurists remain detached from the participants to preserve the integrity of the records established in open meetings, and rulings can be appealed to a higher court.

The idea was to tailor procedures after the court model when the Commissioners act as judges, such as in enforcement actions, and tailor procedures after the legislative model when Commissioners set policy. But the approach was burdened by the hybrid nature of the PUC: Appointed Commissioners make decisions based on a factual record and influenced by casual discussions, with extremely limited judicial review.

Complicating the debate is the fact that Commissioners use a "quasi-judicial process" to reach "quasi-legislative outcomes," that is, to set policy. And the greatest concern is Commissioners drifting from the record in rate-making cases. Rate cases are among the most litigated issues before the PUC, but are legally "quasi-legislative" because rate-making sets policy for how utilities will recover costs.

SB 960 (Leonard), the PUC reform bill of 1996, addressed these issues by establishing three procedural tracks: quasi-judicial, rate-making and quasi-legislative. In the judicial cases, there would be no *ex parte* contact, and as provided in separate legislation, SB 1322 (Calderon), some judicial review. In rate-making cases, *ex parte* contacts would be restricted. And in quasi-legislative cases, *ex parte* contact would be unrestricted.

In the future, the Commission will be conducting far fewer rate cases.

As a greater portion of utility bills are determined by competitive services, the PUC's rate-setting process will determine an increasingly smaller portion of utility bills.

Commission proceedings, at least through the transition to competitive markets, will continue to have enormous consequences for company profits and ultimately consumer prices. But many of those issues will be resolved in policy-making or quasi-legislative proceedings -- not rate-making or quasi-judicial cases.

In the quasi-legislative cases, there are no restrictions on *ex parte* contacts and the same level of judicial review that was set by the Legislature in 1912 remains in effect.

Proponents of greater judicial review believe that a reasonable opportunity to appeal by itself will encourage Commissioners to rely only on the record to make decisions and increase the Commission's motivation to ensure due process.

The experience in other states shows that more opportunity for judicial review does not result in a rush of costly litigation. Florida and Texas, two large states with a lower threshold for judicial review and the highest number of appeals in the nation, average a dozen appeals a year.<sup>154</sup> Most participants are deterred from filing frivolous appeals because they have a number of other cases pending before the commissions and are reluctant to formally challenge rulings in the hope of getting a better result in the courts.

The consumer group TURN said more than anything else, judicial review would infuse a reality check into the PUC's process:

*The absence of effective judicial oversight is now well known to the CPUC itself, as well as to the parties. Such knowledge naturally creates a sense of omnipotence in the agency that breeds arbitrary and sometimes even careless decision-making. TURN believes that an effective threat of judicial review, perhaps as much as the reality of the review itself, will restore a sense of*

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***“TURN believes that an effective threat of judicial review, perhaps as much as the reality of the review itself, will restore a sense of self-discipline to the agency that most observers agree is sadly lacking today.”***

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*self-discipline to the agency that most observers agree is sadly lacking today.*<sup>155</sup>

Similarly, consumer advocates in other states with greater judicial review say their standing in the regulatory arena is enhanced by the regulator knowing that a decision can be appealed.<sup>156</sup>

Most of the participants in PUC proceedings believe there should be more opportunity for judicial review, and virtually all believe that the concern over excessive litigation can be eased by some common restraints. The most widely supported way to efficiently deal with appeals is to restrict cases to a single intermediate court, so that a group of jurists could develop some expertise, be able to respond to appeals quickly, and be more likely to write consistent decisions.

It was suggested during legislative deliberations that the appropriate appeal for legislative-like decisions should be to the Legislature. But it seems inappropriate, costly and destructive to an efficient market to encourage competitors and consumers to go through the PUC process, and then "appeal" to the open-ended legislative process.

The legislative process has proven itself most productive in those case where its sets policy goals and allows oversight agencies to implement them. If the policy choices turn out to be wrong or are rendered obsolete by time, the Legislature should revisit them. If during policy implementation, a participant believes the public process was unfair or rights were denied, the most appropriate place to test those complaints against the standards and precedents of the land is in the judiciary.

While people often complain about the time it takes courts to review issues, there is widely held confidence that the courts will act -- and will act consistently. The Legislature, however, is under no formal obligation to respond to appeals, or to respond in a timely matter to make decisions based on the facts of a case or with regard to precedents.

## *Next Steps*

Creating the accountability within the PUC that consumer groups, businesses and policy makers need is a multi-faceted task. Some of those other facets are described in other portions of this report: The Commission, in cooperation with the Legislature needs to set annual goals and be assessed to see if those goals are met. Commissioners need to have a realistic workload so they are not expected to do the undoable. Commissioners also should put a priority on being part of the fact gathering process -- and not just the final decision maker.

But there is another critical element: Because they are not elected officials, yet are charged with fashioning and enforcing rules that affect essential services and determine mountains of profits -- they must make decisions, even policy decisions, based on a factual record.

There are two tried-and-true mechanisms that we know will help make this happen. The first is public debate and public decision making. And the second is the opportunity for a separate authority -- the courts -- to review appeals based on the assertion that the facts were disregarded in the process.

The Commissioners' rationale for *ex parte* meetings is their need to have complex cases telescoped for them -- because they are too busy to attend any of the hearings or review all of the written material -- and they need the opportunity to ask questions. In the future, if the Little Hoover Commission recommendations are followed, they would have a significantly reduced workload and be able to concentrate on the specifics of cases by attending more of the public hearings. In addition, since the law now allows for summary arguments before the Commission, each Commissioner should have the opportunity to ask questions of participants.

A large difference between the PUC and the Legislature is that legislators are elected directly by the people. In addition, with many more legislators and many more issues, the impact of individual contacts is diluted. And of equal importance, even when setting policy, the Commissioners are expected to make legally and factually supported decisions based on the record established in the case -- something that is undermined in perception if not reality by *ex parte* contact and could be assured with greater judicial review.

## ***Recommendations***

***Recommendation 13-A: The Governor and the Legislature should amend the Public Utilities Code to limit ex parte contacts after a proposed decision is issued in rule-making proceedings to meetings in which all the parties are invited to attend. All private meetings and discussions between Commissioners and parties with a matter pending before the Commission should be noticed and summarized for the public record.***

The Legislature in SB 960 made significant improvements in the PUC's decision-making process. That effort could be further advanced by increasing the accountability in policy-making proceedings, as well. The greatest conflict between the need for Commissioners to discuss issues with individual parties and to preserve the integrity of a fact-based process from political lobbying is after proposed decisions are issued. The integrity of the process will be further enhanced if the notification procedures are expanded to include substantive policy discussions between Commissioners and parties -- even if they are not based on the particulars of a pending case.

***Recommendation 13-B: As the workload of the PUC is reduced -- and as some of its functions are transferred to agencies more suitable to perform them -- the Legislature and the Governor should enact legislation requiring Commissioners to rely solely on open meetings to gather information and make public decisions.***

Even when acting in a policy-making capacity, Commissioners differ fundamentally from legislators: They are not elected and so are never held directly accountable to the public. And with a membership of only five, the effects of special interest lobbying are significantly more concentrated than in a 120-member legislature. As the number of market players increases, the importance of giving everyone a chance to speak -- and listen to the arguments made by their adversaries -- will increase in importance. As its caseload is diminished by transferring some responsibilities to agencies better able to perform them, relying on an open decision-making process will be possible.

***Recommendation 13-C: The Governor and the Legislature should grant parties a right to appeal all PUC decisions, or the decisions of its successor agencies, to the court of appeal.***

The experience in other states is that the accountability provided by broader judicial review can be achieved without significant delays in the public process. To encourage uniformity of decisions and subject expertise, the appeals should be restricted to the court located in the same city as the Commission, now the First District Court of Appeal in San Francisco. The standard of review should include a review of the facts to determine if they support the Commission's decision.



# Flexible Work Force

**Finding 14: The PUC's reputation for hiring and promoting the best and the brightest is being undermined by the rigidity of civil service rules.**

**T**he civil service system rigidly prescribes how managers will make decisions concerning job assignment, rewards and punishments. Those are all factors that will heavily influence how well the Public Utilities Commission is able to remake itself for the post-monopoly future.

How successfully the PUC manages to transform itself may well depend on the ability of Commissioners and senior management to enlist the full support and tap the deep creativity of its staff. The PUC staff is known throughout the civil service for its commitment and its expertise.

But the same independence that the staff brings to the job it applies to its workplace relationships. Keeping that energy focused on serving the public interest will require great skill, all of the tools available to modern managers, and a commitment to create a partnership between management, supervisors and rank and file employees.

Fortunately there are some opportunities to experiment in ways that can give managers more flexibility and restore the Commission as a good place for bright minds to work, without sacrificing the protections against favoritism or worker rights.

## *The Civil Service*

The civil service system was designed to prevent patronage in government employment and to foster a permanent core of public employees. The amalgam of rules and procedures crafted to achieve those ends values stability: A stable work force comprised of employees who work their way up through the ranks to more senior positions. Stable job assignments and functions that allow organizations to perform routinely as personnel changes. Stable resources that allow individuals and organizations to go about their work uninterrupted. Several elements characterize the system:

- ***Examination and selection.*** To ensure that employees are hired based on merit rather than politics, all qualified applicants must take examinations and selection is limited to those who score highest on the exams. However, the process often leads to high costs and time consuming procedures and often does not result in finding the best person for the job. Many of the best prospective applicants are discouraged by the process, or find suitable employment before the state process is complete. And the process does not give enough flexibility to managers to find the right person for a critical position.
- ***Classifications and job assignment.*** To prevent management abuses, workers are hired into fixed classifications that have precise qualifications and job assignments. In order to avoid the burdens of the selection process, organizations often create unique classifications that then limit how those workers can be reassigned. Promotions, reassignments and changes to classifications have to be approved by at least one, and often two, central personnel agencies.
- ***Compensation.*** Compensation is restricted by the classification. While public employees are often motivated by a desire to serve the public, the restrictions on compensation make it virtually impossible for managers to reward workers who have taken on additional or temporary challenges -- putting out extra effort and putting in extra time. Similarly, the rules make it difficult for managers to link raises provided for within classifications to employee performance.
- ***Lay-Off provisions.*** Restrictions on lay offs make it difficult to reduce the work force when necessary, and even more difficult to surgically reduce the work force to keep the best workers in the right jobs. The lay-off provisions also complicate the hiring process by requiring state agencies to review as part of the selection process all employees who are facing layoff in other agencies.

## *How Civil Service Rules Hamper the PUC*

The PUC has had difficulties with its personnel management even before it started to address the organizational changes demanded by an evolving mission and the pressures to reduce its workload.

After months of negotiations, the Commission in 1995 settled a complaint brought by the federal Equal Employment Opportunity Commission that the PUC had discriminated against older workers in promotions to senior positions. The Commission is now operating under a consent decree that requires it to take certain steps in the examination and promotion process to eliminate any bias based on age.

The PUC also has had running disagreements with the Department of Personnel Administration over high-paying classifications that have been created to attract employees to difficult, but temporary tasks. The personnel authority is concerned that the classifications lock the Commission into permanently paying high salaries to employees after the task is completed. The PUC maintains the specialized classifications are needed to retain highly competent workers to fill highly stressful positions when they are being courted away by the companies the PUC regulates.

As the Commission has come under scrutiny for its continuing role over deregulated industries, the PUC's staff has shrunk and key management positions have gone unfilled for months at a time. More recently, the Commission has requested an increase in the number of authorized positions -- at time when the expectation is for the Commission to get by with fewer resources.

These issues existed before the Commission began to formally recognize that its size, mission and procedures will have to be reformed to reflect trends within the industries it regulates. Those changes will create even more challenges for personnel managers and labor representatives to create an environment that satisfies fairness concerns, protects the established rights of workers, meets the needs for managers, wisely uses public resources and sustains the Commission's nationwide reputation as an outstanding venue for public-minded professionals to serve the public. Already, the limitations on work schedules, reward systems and job assignments are making it difficult for the Commission to retain its best workers.

Ironically, among those concerned that the Commission is not hiring, promoting, managing and rewarding its staff are the regulated industries -- particularly telecommunications companies -- that are luring away some of the Commission's best and brightest. While those companies want the expertise of former PUC employees to help them gain an advantage in the regulatory venue, they also want the PUC to be staffed with people who can competently and creatively resolve issues.

One of the hardest hit divisions within the Commission is Ratepayer Advocates. With 205 authorized positions, the division in the summer of 1996 was down to 150 employees. The division's telecommunications branch devolved in two years from a staff of 55 to a staff of 34. Most of the employees went to work for the businesses they once scrutinized.

The Commission's Vision 2000 process also demonstrated that many of the cultural attributes that guide the PUC's regulatory procedures also shape the internal machinations. Employees were amazingly frank with their superiors during the very public process to identify organizational failures, and felt free to criticize proposals once they were formulated by Commissioners. In response to a plan to break up the Division of Ratepayer Advocates and place those workers throughout the organization, a 10-page memorandum was crafted and signed by more than 90 members of the division, including key staff involved in the Vision 2000 process.

## *Creating Flexibility*

The Commission, in its Vision 2000 process, identified as a problem the large number of specialized classifications that will make it difficult to reassign workers as the Commission's functions change. The report's recommendations included creating incentives to reward hard work and creativity, implementing a newly crafted appraisal system, broadening classifications, and seeking relief from civil service restrictions.

The Little Hoover Commission's 1995 civil service reform report, *Too Many Agencies, Too Many Rules*, identified an under-used mechanism for state agencies to cooperate with labor unions and receive relief from the statutory obligations that discourage innovation in personnel management. Government Code section 19600 allows for departments to apply to the State Personnel Board for permission to establish demonstration projects for civil service reform.

Demonstration projects have been used by federal agencies and departments in other states to create partnerships between rank and file workers and managers that helped to get past old problems and address new challenges. The demonstration projects have proved particularly fruitful in agencies that needed to reorganize how they would fulfill their mission with fewer resources.

As a demonstration project, the PUC could gain flexibility in how it established qualification requirements, recruited and appointed employees; how it classified and compensated employees; how it reassigned and promoted employees; how it provided incentives and disciplined employees; how it involved labor organizations in personnel decisions and made reductions in staff.

## ***Recommendations***

***Recommendation 14: The Commission should apply to the State Personnel Board for permission to initiate a demonstration project. The project should allow for the creation of broader classifications and pay for performance. The Commission should initiate a labor-management council for anticipating, assessing and resolving labor-related problems that will result from the near-constant change facing the Commission.***

As the PUC's role radically shrinks, it is in a unique position to benefit from the flexibility that the Legislature already has granted to state agencies facing considerable changes and looking for ways to forge a partnership between management and labor that transcends the rigidity of the civil service rules.



# Conclusion





# Conclusion

In 1876 the Supreme Court of the United States heard the appeal of Scott & Munn, owners of a Chicago grain elevator firm that had been fined \$100 for not obtaining a license to operate. The businessmen made no excuse for their actions. Rather they insisted the Constitution of the State of Illinois violated their rights by regulating warehouses such as theirs. The court ruled that by storing the grain harvested in the western states and loading it into eastbound ships and rail cars, Scott & Munn had crossed the line defining strictly private concerns. As a result, they could be subjected to government rules intended to protect the community's interest.

"Property," the majority opined, "does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large."<sup>157</sup>

That ruling has been a touchstone for a century of utility regulators, who acted on behalf of the community at large to guard whatever interest individuals could not ensure on their own. When the utility service was provided by a monopoly company, the regulation was nearly absolute -- controlling not just price but the thousands of decisions and factors that comprised the delivery of an essential service.

In the 120 years since *Munn vs. Illinois*, a social and technological evolution has occurred simultaneously affirming the court's wisdom while requiring its application to be reconsidered strand by strand.

As never before, electricity and telecommunications weave individuals into the social and economic fabric. Similarly, water and transportation

services -- with their effect on the health and safety of individuals and entire communities -- is enmeshed with the public interest. The relationship between these products and the public welfare does not rest on whether these products are provided by one supplier or a thousand suppliers.

However, dramatic changes in technologies and the marketplace has altered the nature of the public interests that need protection, and the ways and means that government should attempt to guard those interests.

Policy makers have decided -- first in regards to transportation, then telecommunications and natural gas, and now electricity -- that competition is viable in these industries and that competition will produce better services at lower costs than tightly regulated markets with limited suppliers.

As a result, the public does not need agencies commissioned to make marketplace decisions. Rather the public -- both consumers and producers -- need government agencies that allow them to make decisions with confidence: that environmental and public health concerns will be addressed efficiently, that anticompetitive behavior will be policed, that the physical system will operate reliably, that social programs will be administered effectively.

In short, the public interest is being redefined, and government agencies must be realigned to that new public interest.

The challenge facing government is well described by the chairman of the Alliance for Competitive Communications, a coalition of the regional bell companies. The chairman warned the National Association of State Utility Consumer Advocates that no shelter would protect regulators from the same market forces buffeting the telecommunications industry:

*Your situation, in fact, is ironically similar to mine, as a Bell company executive. We're used to doing things for many reasons other than competitive demands. Both of our mandates have been based on the explicit separation of competitive markets from non-competitive, or monopoly markets. We work in a world that is so dominated by complex regulatory formulas and subsidies that no one laughs if someone says that when you increase competition, prices go up.*

*Well, the distant thing you hear is the storm of competition getting ready to rage in our industry. And it's going to require that you all make some changes in your approach to your jobs or its going to blow you away as surely as we telephone companies will be blown away if we don't change. And lesson number one, is that in the real world, real competition makes prices go down, not up.*

*You can make the promised benefits of competition -- lower rates, increased choice, greater availability of advanced new services -- realities in the areas you serve. That means -- not looking backward to the old way of doing things and struggling to protect pockets of the industry from the gale of competition -- but looking forward to the opportunities that real competition can bring to consumers in all areas of communications today.*<sup>158</sup>

In charting this future course, the State should remember where it has stumbled before.

Among the lessons that have been learned is that fourth-branch commissions are not effective when their workload is so large that commissioners must delegate policy making authority to their staff or rely on private meetings to make up for the hours of public debate that they missed.

The State has learned that giving two commissions overlapping duties is better at stopping events from happening than making desired outcomes a reality. Dueling commissions are particularly good at frustrating progress when those commissions are left to pursue newly plotted policy directions without the guidance of elected lawmakers and the State's executive.

The State also has learned intervention is a hard habit to break. Agencies, such as the PUC, were born to regulate and are genetically programmed to intervene in the marketplace: Every statute, every regulation, every procedure is premised on a need of the agency to make a decision that consumers and producers would otherwise make.

The recommendations in this report were fashioned with these and other lessons in mind: single commission oversight of essential industries; a statutory mandate biasing government in favor of market solutions; policy making collaboration between fourth-branch commissions and the Legislature and Governor; accountable public decision making and effective consumer protection.

Given the choice already made by policy makers to open utility markets to as much competition as the market will generate requires that the State develop a structure that matches the new market.

Consumer groups and some market players are concerned about the pace of government's reformation. While they trust the marketplace, they do not trust the historic monopolies. Those concerns are valid. But the storm now on the horizon has been approaching for years and government has been slow to respond. The recommendations of the Little Hoover Commission were crafted to make the government transition as smooth as possible. But the pace should be dictated by the needs of the governed, not the convenience of government.



# Appendices





## APPENDIX A

### Little Hoover Commission PUC & Energy Advisory Committees

The following people served on the advisory committees for the PUC & Energy study. Under the Little Hoover Commission's process, advisory committee members provide expertise and information but do not vote on the final product.

#### Energy Advisory Committee

Barbara Barkovich  
Barkovich & Yap, Inc.

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Jananne Sharpless  
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California Manufacturers Assn.

Emilio Varanini  
Marron Reed & Sheehy

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Pacific Bell

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Secretary  
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Southern California Water Company



**APPENDIX B**  
**Witnesses Appearing at**  
**Little Hoover Commission PUC/Energy**  
**Public Hearing**

**March 27, 1996**  
**Sacramento**

Virginia Coe  
Former Director of Strategic Planning  
Public Utilities Commission

P. Gregory Conlon  
President-elect  
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Charles Imbrecht  
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Douglas Wheeler  
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Carl Blumstein  
Research Policy Analyst  
California Energy Institute  
University of California, Berkeley

Peter Navarro  
Professor  
Economics and Public Policy  
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**Witnesses Appearing at  
Little Hoover Commission PUC/Energy  
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**April 24-25, 1996  
San Francisco**

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Commissioner  
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**Witnesses Appearing at  
Little Hoover Commission PUC/Energy  
Public Hearing**

**August 28-29, 1996  
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Public Utilities Commission

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GTE California

John Gueldner  
Vice President, Regulatory Affairs  
Pacific Telesis Group

Randolph Deutsch  
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Law and Government Affairs  
AT&T

Jim Lewis  
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MCI Communications

D.O. Helmick  
Commissioner  
California Highway Patrol

Grace Hughes  
President  
Marin Airporter

Joel Anderson  
Executive Vice President  
California Trucking Association

Larry D'Addio  
General Manager  
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California Water Association

Craig M. Wilson  
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Cliff Sharpe  
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Herschel T. Elkins  
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Antitrust Section



# Endnotes

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64. Public Utilities Commission, "A Report on Our Process for Change: Vision 2000," July 1995, Appendix A-3.
65. Randolph Deutsch, vice president, law and government affairs, AT&T, in testimony to the Little Hoover Commission, August 28, 1996, in Sacramento.
66. The PUC has declined to allow for new area codes to be "overlaid" on existing area codes until technology is implemented allowing customers to maintain the same telephone number when they change carriers. Commissioners, in applying this policy to the 310 and 818 area codes, acknowledged in August and October 1996 meetings that this requires changing the telephone numbers of existing customers rather than new customers.

67. Tony Armstrong, director, governmental affairs, GTE California, testimony to the Little Hoover Commission, August 28, 1996, Sacramento.
68. John Gueldner, vice president, regulatory affairs, Pacific Telesis Group, testimony to the Little Hoover Commission, August 28, 1996, Sacramento.
69. In October of 1993, the Senate and Assembly utility committees held a joint hearing on the "Improprieties in the PUC's Toll Rate Decision." The Legislature subsequently asked an Advisory Group, chaired by former PUC President Donald Vial, to review PUC procedures and offer reforms. The incident was also described in testimony from James L. Lewis, regional executive for MCI, to the Little Hoover Commission, August 28, 1996.
70. Robert C. Fellmeth, director, Center for Public Interest Law, University of San Diego, in written testimony to the Little Hoover Commission, August 29, 1996.
71. Donald Vial, et al., "Report of the Advisory Working Group on CPUC Reforms," to the Senate Subcommittee on Public Utilities Commission Reforms of Senate Committee on Energy and Public Utilities, June 1, 1994.
72. G. Mitchell Wilk, Concurring Opinion, Advisory Group Final Report to the California State Senate Subcommittee on PUC Reform, May 16, 1994.
73. Josiah Neeper, Commissioner, Public Utilities Commission, in a meeting of the Commission on June 19, 1996, in San Francisco.
74. Taylor and Zona, op. cit; Leland L. Johnson, *Price Caps in Telecommunications Regulatory Reform*, A Rand Note, Rand Library Collection, January 1989.
75. Charles F. Phillips Jr., "The Changing Structure of the Public Utility Sector," *Public Utilities Fortnightly*, January 9, 1986.
76. Robert W. Crandall and Leonard Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications*, The Brookings Institution, 1995.
77. Jerry Hausman, MacDonald professor of economics, Massachusetts Institute of Technology, in testimony to Congress, October 12, 1995.
78. Gueldner, op. cit.
79. Richard Nelson, Director of State Regulatory Affairs, AirTouch Communications, Inc., in comments to the Little Hoover Commission Water, Telecommunications and Transportation Advisory Committee, June 12, 1996.
80. Wilk, op. cit.
81. Armstrong, op. cit.
82. California Public Utilities Code, Sections 1031 - 1042; Rules 1 through 8, 15, 15.1, 16 and 21, Rules of Practice and Procedure, California Public Utilities Commission.
83. Taylor and Zona, op. cit.; Johnson, op. cit.; Crandall and Waverman, op. cit.

84. William R. Schulte, former chief, Transportation Division, Public Utilities Commission, in an interview with the Little Hoover Commission staff, October 1996.
85. Douglas Hill, president, California Moving and Storage Association, in an interview with the Little Hoover Commission staff, June 13, 1996.
86. Fellmeth, op. cit.
87. Taylor and Zona, op cit.; Johnson, op cit.; Crandall and Waverman, op cit.
88. Crandall and Waverman, op cit.
89. Grace Hughes, president and chief executive officer, Marin Airporter Company, testimony to the Little Hoover Commission, August 28, 1996 in Sacramento.
90. Fessler, testimony to the Little Hoover Commission, op. cit.
91. Alan Shanedling, owner, Fleetwood Limousine Company, in remarks to the Little Hoover Commission Advisory Committee on Water, Telecommunications and Transportation, June 25, 1996.
92. D.O. Helmick, commissioner, California Highway Patrol, in testimony to the Little Hoover Commission, August 28, 1996 in Sacramento.
93. Rebecca Brady, National Conference of State Legislatures, in an interview with the Little Hoover Commission staff, June 5, 1996.
94. Deregulation Task Force [and] Dean R. Dunphy, secretary, Business, Transportation and Housing Agency. *Report to Governor Pete Wilson*. [no date].
95. Ed Snyder, interim deputy director, Industry Operations Division, California Department of Motor Vehicles, in an interview with the Little Hoover Commission staff, June 1996.
96. Joel Anderson, executive vice president, California Trucking Association, in testimony to the Little Hoover Commission, August 28, 1996.
97. Hill, op. cit.
98. Douglas Hill, president, California Moving & Storage Association, letter to the Little Hoover Commission, July 1, 1996.
99. Texas, New Mexico, New Jersey, Missouri, Arkansas, Minnesota, and Kentucky have assigned regulation of transportation carriers to transportation agencies other than the public utilities commission. Roger Dunstan, California Research Bureau, California State Library, memorandum to the Little Hoover Commission, February 14, 1995.
100. J.D. Stokes, safety/traffic engineer, Technological Applications Section, California Division, Federal Highway Administration, interview with Little Hoover Commission staff, September 30, 1996.
101. Darin Kosmak, railroad liaison branch manager, Traffic Operations Division, Railroad Section, Texas Department of Transportation, interview with the Little Hoover Commission

staff, September 9, 1996.

102. Bill Chappell, Traffic Engineering Branch, North Carolina Department of Transportation, interview with the Little Hoover Commission staff, September 24, 1996.

103. Bruce DeBerry, deputy director, Safety and Enforcement Division, Public Utilities Commission, interview with the Little Hoover Commission staff, September 27, 1996.

104. "Accidents That Shouldn't Happen: A Report of the Grade Crossing Safety Task Force to Secretary Federico Pena," U.S. Department of Transportation, March 1, 1996.

105. "California Trade and Goods Movement Study," prepared for the California Department of Transportation and the San Diego Association of Governments by Barton-Aschman Associates, Inc., June 1996.

106. "Intermodal Freight Transportation: Projects and Planning Issues," *Reports and Testimony*, U.S. Government Accounting Office, July 1996.

107. Robert A. Wolf, undersecretary for the California Transportation, Business, Transportation and Housing Agency, Memorandum to George Dunn, Cabinet Secretary, Governor's Office, June 26, 1996.

108. Ibid.

109. Fred L. Curry, program manager, Water Division, Public Utilities Commission, in an interview with Little Hoover Commission staff, September 24, 1996.

110. California Public Utilities Commission, *Annual Report*, 1994-1995.

111. "Analysis of Ex Parte Contact Notices Filed at the California Public Utilities Commission, January 1 - July 31, 1995," prepared by William B. Marcus, Gregory A. Ruzovan and Gayatri M. Schilberg, JBS Energy, Inc., September 1995.

112. David N. Kennedy, director, California Department of Water Resources, letter to the Little Hoover Commission, June 27, 1996.

113. Deborah Braver, program manager, Water Management Planning, California Department of Water Resources, interview with the Little Hoover Commission staff, September 17, 1996.

114. Kennedy, op. cit.; "Bulletin 160-93, The California Water Plan Update, October 1994," California Department of Water Resources.

115. "Bulletin 160-93, The California Water Plan Update, October 1994," California Department of Water Resources.

116. Kennedy, op. cit.; Braver, op. cit.; California Urban Water Conservation Council, "Memorandum of Understanding Regarding Urban Water Conservation in California, Best Management Practices Summary Report, 1993-1994."

117. "Bulletin 160-93," op. cit.; Kennedy, op. cit.

118. Kennedy, op. cit.
119. Curry, op. cit.
120. Tom Smagel, Water Division, Public Utilities Commission, in an interview with the Little Hoover Commission staff, September 24, 1996.
121. "California Urban Water Conservation Council: An Independent Evaluation of the Council's Structure, Activities and Budget and Future Directions in Urban Water Conservation, Final Report;" Energy Resources International, Inc., January 26, 1996.
122. Curry, op. cit.
123. David N. Kennedy, director, California Department of Water Resources, in a letter to Daniel William Fessler, President, California Public Utilities Commission, May 9, 1994.
124. Ibid.
125. Joseph F. Young, vice president, Southern California Water Company, in an interview with Little Hoover Commission staff, November 5, 1996.
126. Ibid.
127. John Garon, vice president, Santa Clarita Water Company, in an interview with Little Hoover Commission staff, October 25, 1996.
128. Young, op. cit.
129. Dean Evans, deputy director, Water, Commission Advisory and Compliance Division, Public Utilities Commission, in an interview with Little Hoover Commission staff, June 14, 1996.
130. Clifford A. Sharpe, chief, Drinking Water Field Operations Branch, California Department of Health Services, interview with Little Hoover Commission staff, September 20, 1996.
131. Curry, op. cit.
132. Clifford A. Sharpe, chief, Drinking Water Field Operations Branch, California Department of Health Services, interview with Little Hoover Commission staff, June 14, 1996.
133. Ibid.
134. Joseph F. Young, vice president, Southern California Water Company, in remarks to the Little Hoover Commission Water, Transportation and Telecommunications Advisory Committee, June 25, 1996.
135. Sharpe, September 20, 1996, op. cit.
136. Larry D'Addio, general manager, Citizens Utilities Company of California and president, California Water Association, in testimony to the Little Hoover Commission,

August 28, 1996.

137. Sharpe, September 20, 1996, op. cit.

138. D'Addio, op. cit.

139. Interview with staff of the Texas Natural Resources Conservation Commission, May 1996.

140. Douglas P. Wheeler, Secretary for Resources, in a letter to the Little Hoover Commission, August 22, 1996.

141. Memorandum from Public Utilities Commission Division of Ratepayer staff to PUC Commissioners P. Gregory Conlon, Daniel Wm. Fessler, Jessie J Knight, Jr., Henry M. Duque, Josiah L. Neeper and Executive Director Wes Franklin, July 15, 1996.

142. Michael Shames, executive director of the Utility Consumers' Action Network, in a Letter to the Little Hoover Commission, January 23, 1996.

143. Ibid.

144. Edmund J. Texeira, former director, Public Utilities Commission, Division of Ratepayer Advocates, in testimony to the Little Hoover Commission, August 29, 1996 in Sacramento.

145. Coe, op. cit.

146. Fellmeth, op. cit.

147. California Business and Professions code section 17200 et seq.

148. Herschel T. Elkins, senior assistant attorney general for consumer law, California Attorney General's Office, in testimony to the Little Hoover Commission, August 29, 1996 in Sacramento.

149. Thomas Greene, senior assistant attorney general, antitrust section, in testimony to the Little Hoover Commission, August 29, 1996.

150. V. John White, executive director of the Center for Energy Efficiency and Renewable Technologies, Little Hoover Commission PUC / Energy Advisory Committee, May 15, 1996.

151. Florio, op. cit.

152. Boyd, op. cit.

153. Alan Gardner, California Cable Television Association, in remarks to the Little Hoover Commission PUC / Energy Advisory Committee. July 9, 1996.

154. Richard Severy, government affairs director, MCI Communications, in remarks to the PUC / Energy Advisory Committee, July 9, 1996.

155. Florio, op. cit.

156. Fred Schmidt, Advocate for Customers of Public Utilities, and Sonny Popowski, Consumer Utility Advocate, Commonwealth of Pennsylvania, in interviews with Commission staff.

157. *Munn vs. Illinois*, op. cit.

158. Gary McBee, chairman, Alliance for Competitive Communications, in a speech to the Washington Telecommunications Conference, National Association of State Utility Consumer Advocates, May 4, 1995.

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## CALIFORNIA LEGISLATURE

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CHARLES POOCHIGIAN

December 2, 1996

Chairman Richard R. Terzian  
Little Hoover Commission  
660 J Street, Suite 260  
Sacramento, CA 95814

Dear Richard:

During much of my career in public service, I fought for a California energy policy that would satisfy the state's growing demands in an economically efficient and environmentally sound manner. That balanced approach was the premise for legislation more than two decades ago that created the California Energy Resource Conservation and Development Commission. The work of the Energy Commission has become a national model for encouraging new technologies and diversity in energy sources while balancing the economic and the public health and safety concerns at stake when large new power plants are sited.

As I leave public office, I remain convinced that a balanced and assertive state energy policy will be as essential in an era of competitive energy services as it was in the days of monopoly power utilities. But I also realize that as competitive forces are unleashed in an effort to provide better service at lower prices, the state will need to realign the agencies charged with protecting those public interests that are indivisible from the development and distribution of energy resources.

Generally, I believe the realignment outlined in the Little Hoover Commission's proposed PUC & Energy report would provide the constant diligence needed to protect public values while encouraging the markets to provide efficient service. By gradually assigning to the Energy Commission the regulatory duties needed to make competitive energy markets work, California could also end years of tension between the state's energy-related regulatory agencies.

From the perspective of a co-author of the Act, it is unclear that the Hoover Commission proposal to remove the CEC's efficiency and R&D authority is appropriate.

At the time the Act was drafted, the authors had a key goal: For the first time (anywhere in the U.S.) to enfranchise one energy authority with four key responsibilities--forecasting electricity demand, siting power plants needed to meet that demand, mandating efficiency standards to reduce demand, and developing "alternative" technologies through R&D to ensure that power plant options are as benign as possible.

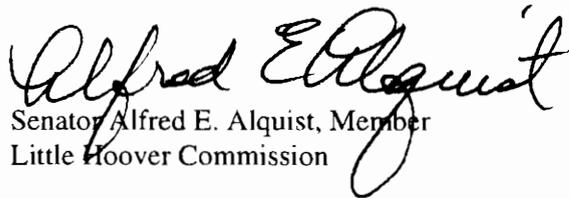


Transfer of two of the four key functions to an entirely separate, new regulatory agency (particularly one with little experience in energy) would fundamentally undermine the integrated policy approach envisioned by the authors and legislature. In addition, the transfer at this time will jeopardize the timely implementation of AB 1890. If the transfer must occur, it should occur after the implementation date of January 1998.

The Public Utilities Commission, I believe, has been a valuable asset to the State during nearly a century of monopoly utility service. But I also agree with the report's recommendations that the best value the PUC could now provide Californians would be to focus on nurturing the most competitive and universally available telecommunications services possible.

With the exception of transferring the efficiency and R&D functions, I endorse the plan before the Little Hoover Commission. However, if my long tenure on the Little Hoover Commission had lasted but one month more, I would vote for adoption. I also would urge those who follow me in the Legislature to embrace the organizational reforms recommended by the Little Hoover Commission.

Sincerely,



Senator Alfred E. Alquist, Member  
Little Hoover Commission







## LITTLE HOOVER COMMISSION FACT SHEET

The Little Hoover Commission, formally known as the Milton Marks "Little Hoover" Commission on California State Government Organization and Economy, is an independent state oversight agency that was created in 1962. The Commission's mission is to investigate state government operations and -- through reports, and recommendations and legislative proposals -- promote efficiency, economy and improved service.

By statute, the Commission is a balanced bipartisan board composed of five citizen members appointed by the Governor, four citizen members appointed by the Legislature, two Senators and two Assembly members.

The Commission holds hearings on topics that come to its attention from citizens, legislators and other sources. But the hearings are only a small part of a long and thorough process:

- \* Two or three months of preliminary investigations and preparations come before a hearing is conducted.
- \* Hearings are constructed in such a way to explore identified issues and raise new areas for investigation.
- \* Two to six months of intensive fieldwork is undertaken before a report -- including findings and recommendations -- is written, adopted and released.
- \* Legislation to implement recommendations is sponsored and lobbied through the legislative system.
- \* New hearings are held and progress reports issued in the years following the initial report until the Commission's recommendations have been enacted or its concerns have been addressed.

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